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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

SOUTHWESTERN BELL TELEPHONE COMPANY,
Petitioner,

v.

FEDERAL COMMUNICATIONS COMMISSION
and UNITED STATES OF AMERICA,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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PETITION FOR A WRIT OF CERTIORARI

MARTIN E. GRAMBOW
Southwestern Bell Corporation
—Washington, D.C.
1401 I Street, N.W., Suite 1100
Washington, D.C. 20005
(202) 326-8868

JAMES E. TAYLOR
RICHARD C. HARTGROVE
THOMAS A. PAJDA
Southwestern Bell Telephone Company
One Bell Center, Room 3520
St. Louis, Missouri 63101
(314) 235-2507

JOHN I. STEWART, JR.*
ROBERT M. HALPERIN
STEPHEN M. BYERS
CROWELL & MORING
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2595
(202) 624-2500

** Counsel of Record for the Petitioner*

March 17, 1994

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTIONS PRESENTED

1. When the Federal Communications Commission's second successive decision explaining its rejection of a tariff filing fails to reconcile inconsistencies and ambiguities in its rationale, to such an extent that the court of appeals characterizes aspects of its explanation as "opaque," "contradictory" and "confusing" and the Commission's own counsel concedes that he is "mystified" by decisional language that "seems like the work of gremlins," may the court nonetheless affirm that decision on the basis of a reading of prior orders that the Commission did not rely upon until its appellate brief?

2. When an agency interprets a prior order, which established an entirely new system of economic regulation, as having absolutely precluded the filing by a regulated company during the transition period of a request seeking to correct the "starting point" for that new regulatory regime, should the reviewing court require such an interpretation to be based on demonstrably clear and unambiguous notice in the prior order?

PARTIES TO THE PROCEEDING BELOW

In the proceedings before the United States Court of Appeals for the District of Columbia Circuit, Southwestern Bell Telephone Company* was the sole petitioner. The respondents were the Federal Communications Commission and the United States of America. The American Telephone and Telegraph Company and MCI Telecommunications Corporation intervened in the case but did not submit briefs.

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* Pursuant to Rule 29.1, Petitioners state as follows: Southwestern Bell Telephone Company is a wholly-owned subsidiary of Southwestern Bell Corporation, a publicly held corporation. The principal subsidiaries of Southwestern Bell Corporation, besides Southwestern Bell Telephone Company, are Southwestern Bell Telecommunications, Inc.; Southwestern Bell Mobile Systems, Inc.; Southwestern Bell Media Ventures, Inc.; and Southwestern Bell Publications, Inc.

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PETITION FOR A WRIT OF CERTIORARI

Southwestern Bell Telephone Company hereby petitions for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the District of Columbia Circuit dated December 17, 1993.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the District of Columbia Circuit, dated December 17, 1993, is reported at 10 F.3d 892 (D.C. Cir. 1993) and is reprinted as Appendix A (App. 1a). The Order on Remand of the Federal Communications Commission upholding the rejection of Southwestern Bell Telephone Company's tariff filing, dated March 10, 1993, is reported

at 8 FCC Rcd 2261 (1993) and is reprinted as Appendix B (App. 18a). The prior Memorandum Opinion and Order of the Federal Communications Commission upholding the rejection of Southwestern Bell Telephone Company's same tariff filing, dated May 6, 1992, is reported at 7 FCC Rcd 2906 (1992) and is reprinted as Appendix D (App. 33a). The order of the Common Carrier Bureau of the Federal Communications Commission rejecting Southwestern Bell Telephone Company's tariff filing, dated April 9, 1991, is reported at 6 FCC Rcd 2089 (Comm. Car. Bur. 1991) and is reprinted as Appendix F (App. 71a).

JURISDICTION

The decision of the United States Court of Appeals for the District of Columbia Circuit was issued on December 17, 1993. This Court has jurisdiction over this matter by virtue of 28 U.S.C. § 1254(1).

REGULATORY PROVISIONS INVOLVED

The regulatory provisions involved are 47 C.F.R §§ 61.38, 61.41-49, 69.3 (1992) and 47 C.F.R. § 69.3 (1990) and are set forth in Appendix H (App. 83a).

STATEMENT OF THE CASE

Introduction

The court below affirmed a 1993 decision of the Federal Communications Commission ("FCC" or "the Commission") that rejected a tariff filing submitted by Southwestern Bell Telephone Company ("SWBT") in 1990. The 1993 decision was the Commission's second. After a first unsuccessful attempt to justify its rejection of the filing, the Commission ultimately settled upon the rationale that SWBT's filing had been barred by a set of rules formulated for the purpose of administering a new form of rate regulation, the "price cap" rules. Not until after that second determination was brought before the United States Court of Appeals for the District of Columbia Cir-

cuit on review did the Commission, in its brief, posit an explanation of why the new rules applied in such a way as to preclude SWBT's filing. Contrary to long-established precedent of this Court, the court of appeals upheld the Commission's actions largely on the basis of reasons articulated for the first time in the FCC's appellate brief.

Regulatory Background

Rate of Return Regulation. The FCC for many years regulated the interstate rates of telephone companies, including local exchange carriers ("LECs") like SWBT, by allowing them the opportunity to recover their costs plus a designated rate of return on investment. Under this approach, SWBT and other LECs would submit periodic rate filings setting forth their proposed rates. One set of rates charged by LECs are "access charges," which long distance companies and other customers are required to pay to cover the costs of their use of the LECs' local telephone networks for the provision of interstate services such as long distance telephone calls.

Under the FCC's rate of return rules, LECs submitted annual access charge tariff filings in which they proposed rates which would allow them to recover costs and earn no more than the prescribed rate of return. To support these proposed rates, the LECs provided cost and revenue data for the preceding year, as well as projections of costs and demand for the upcoming twelve-month tariff period. After review by FCC staff and any ordered adjustments, the proposed rates were allowed to take effect for the succeeding twelve-month period.

During the tariff period, an LEC's rates were subject to revisions if, based on actual costs, it appeared that the approved rates would not allow it to recover the permissible rate of return. These revisions were accomplished through "mid-course correction" filings, which, like other tariff filings, were evaluated on the basis of whether the proposed corrections would yield a "just and reasonable" rate.

Price Cap Regulation. On October 4, 1990, the FCC issued a rulemaking order announcing adoption of a new method of rate regulation for LECs, known as "price cap" regulation. *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786 (1990) ("Price Cap Order"), *aff'd sub nom. National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993). Under price cap regulation, each LEC sets rates for particular groupings or "baskets" of services at or below a prescribed "price cap," which generally is only subject to future adjustment based on inflation, productivity and a change in certain types of costs beyond the LEC's control, or extraordinary circumstances. The price cap approach to rate regulation is intended to provide LECs with incentives to cut costs and operate more efficiently by attenuating the link between operating costs and rates.

The Price Cap Order set January 1, 1991 as the effective date of price cap regulation and required LECs to file their initial price cap tariffs on November 1, 1990. The starting point for price cap rates was to be based on each LEC's July 1, 1990 rates, subject to certain adjustments. *Id.* at 6814 ¶ 230.

The Regulatory Actions at Issue

In April 1990, SWBT and other LECs made their annual access charge tariff filings under rate of return regulation, based on protected data for the period from July 1990 through June 1991. SWBT's proposed rates were adjusted downward by the FCC's Common Carrier Bureau ("the Bureau") based on their view of reasonable future costs, and were allowed to go into effect on July 1, 1990. However, by November 1990, SWBT had determined, based on actual data, that the FCC-prescribed rates were unreasonably low. Thus, on December 4, 1990, SWBT submitted a mid-course correction filing, denominated Transmittal No. 2051, to increase its July 1, 1990 access charges by $37.6 million. SWBT later filed Application No. 257 for permission to supplement Trans-

mittal No. 2051 to provide further actual cost and revenue data that demonstrated that the projections relied on by the Bureau to set SWBT's access rates in June 1990 understated SWBT's actual revenue requirements for the 1990-1991 tariff period by a total of $65.9 million.

The Bureau rejected SWBT's mid-course correction filing on April 9, 1991, and subsequently rejected Application No. 257 as moot. *Southwestern Bell Telephone Company Revisions to Tariff F.C.C. No. 68*, 6 FCC Rcd 2089 (Comm. Car. Bur. 1991) (Appendix F, App. 71a); Letter from Chief, Tariff Division, Common Carrier Bureau, dated May 15, 1991 (Appendix E, App. 70a). SWBT appealed these orders.

On May 6, 1992, the FCC released an order generally upholding the Bureau decisions, with one Commissioner dissenting. *Southwestern Bell Telephone Company*, 7 FCC Rcd 2906 (1992) (Appendix D, App. 33a). In its order, the Commission expressed its concern that, in implementing the new price cap system, LECs would engage in "improper" rate increases in the months leading up to price cap regulation. *Id.* at 2908-09 ¶ 19 (App. 42a-43a). Although it admitted that mid-course correction filings made before January 1, 1991 could result in an upward adjustment to the price cap starting point, it said that a footnote to the Price Cap Order implied that such filings would be evaluated under a previously unannounced "heightened" level of scrutiny. *Id.* Applying this higher standard, the Commission rejected SWBT's mid-course correction filing. Commissioner Barrett dissented, calling the Commission's decision "patently unfair," because SWBT did not have notice of any heightened standard for review of mid-course correction filings. *Id.* at 2920 (App. 67a-68a).

SWBT promptly petitioned the court of appeals for review of the Commission's order. After SWBT's opening brief was filed, the FCC requested remand of the case.

The court granted the remand request. Order, D.C. Cir. No. 92-1220 (Oct. 3, 1992) (*per curiam*) (Appendix C, App. 31a). More than five months later, after a Petition for a Writ of Mandamus had been filed by SWBT with the court of appeals seeking a Commission decision, the FCC, in a two-to-one decision, issued a Memorandum Opinion and Order on Remand that once again upheld the rejection of SWBT's mid-course correction filing. *Southwestern Bell Telephone Company*, 8 FCC Rcd 2261 (1993) (Appendix B, App. 18a). Once again, Commissioner Barrett dissented.

In its Order on Remand, the Commission stated that it was affirming the "essential holding" of its original order, but was "tak[ing] this opportunity to clarify the reasoning underlying that decision." *Id.* at 2261 ¶ 2 (App. 19a). In fact, the FCC substantially altered its reasons for rejecting SWBT's filing and recharacterized its original "heightened scrutiny" rationale as an "alternate ground" to support its decision. *Id.* at 2263 ¶ 12 (App. 25a). Under its new approach, the Commission analyzed SWBT's mid-course correction filing as a request for an increase in its price cap rates applicable after January 1, 1991, rather than an attempt to correct the June 1, 1990 rate of return rates on which its price cap starting point was based. Because SWBT's filing failed to meet the rigid requirements that applied to requests for adjustments in price cap rates after the rates became operational on January 1, 1991, the Commission reasoned, it was properly rejected as "patently unlawful." *Id.* at 2263 ¶ 11 (App. 25a). The Commission offered no explanation of how an LEC was to discern from the Price Cap Order that traditional mid-course correction filings to adjust rates established under rate of return regulation would be flatly rejected, except to state conclusorily that SWBT "had adequate notice." *Id.*

The FCC held in the alternative that Transmittal No. 2051 was properly rejected under rate of return regula-

tion, reiterating the arguments on which it had relied in its original Order. It expressly conceded that "the *LEC Price Cap Order* left open the possibility that LECs could file mid-course corrections that would increase their July 1990 rates not only during the period prior to price cap tariffs becoming effective but also thereafter." *Id.* at 2263 ¶ 14 (App. 27a). The FCC found again, however, that a footnote in the Price Cap Order had implicitly suggested that mid-course corrections would be subject to more stringent criteria than those prevailing under rate of return regulation. The Commission repeated, without elaboration, its earlier finding that SWBT's filings would not have satisfied the new more stringent criteria. *Id.*

Commissioner Barrett dissented, repeating his view that SWBT had not been provided with adequate notice that its mid-course correction filing would be treated under a previously unarticulated heightened scrutiny standard, and criticizing the majority for having failed to address this defect once again. *Id.* at 2265-66 (App. 29a-30a). SWBT timely petitioned the court of appeals for review of the Order on Remand.

The Court of Appeals Decision

In its brief to the court of appeals, the Commission, through its appellate counsel, for the first time articulated why the Price Cap Order supposedly required application of the new price cap regulations to mid-course corrections seeking to adjust an LEC's price cap starting point. The FCC's brief claimed that the Price Cap Order made it clear that traditional mid-course corrections would not be accepted at all, relying for the most part on a particular paragraph of the Price Cap Order that had never before been identified as providing the requisite notice. *See* Brief for Respondents at 15-28, *Southwestern Bell Telephone Co. v. FCC* (No. 93-1202).

When pressed by the court at oral argument concerning the Commission's unambiguous statement in the

Order on Remand that the price cap starting point could in fact be adjusted through mid-course correction filings, FCC counsel stated frankly that he was "mystified" by the language in question. When pressed further by the court, counsel stated "that is something I cannot explain away. I have tried to get explanations from the drafters of the document, and it seems like the work of gremlins. . . . We have discussed, pondered, and tried to analyze and digest that paragraph for some time now and have not been able to come up with it." Transcript of Proceedings at 23-24, *Southwestern Bell Telephone Co. v. FCC* (No. 93-1202) (Nov. 9, 1993).

On December 17, 1993, the court of appeals upheld the Commission's Order on Remand, essentially adopting the argument of the agency's appellate counsel. The court found that certain provisions of the Price Cap Order, which the agency itself had never relied upon in attempting to explain why the price cap regulations should apply to mid-course correction filings, provided notice to LECs that mid-course correction filings which would have the effect of increasing the July 1990 rates, and therefore the price cap starting point, would be rejected as a violation of the new price cap regulations. *Southwestern Bell Telephone Co. v. FCC*, 10 F.3d 892 (D.C. Cir. 1993) (Appendix A, App. 1a).

The court conceded that the Commission had been "less than a beacon of clarity," had referred in the Order on Remand to mid-course corrections in an "admittedly opaque and even superficially contradictory" manner, and had used "impenetrable, imprecise language." *Id.* at 893, 899 (App. 3a, 15a, 16a). Nonetheless, the court upheld the argument of the FCC on appeal that the Price Cap Order had provided effective notice that mid-course correction filings would be rejected unless they fit within the narrow constructs set forth in the new regulations to govern post-operational price cap rate adjustment filings.

REASONS FOR GRANTING THE WRIT

I. THE COURT OF APPEALS BASED ITS AFFIRMANCE OF THE FCC'S DECISION ON A RATIONALIZATION SUPPLIED BY APPELLATE COUNSEL, CONTRARY TO THIS COURT'S CLEAR PROSCRIPTION.

The court of appeals panel here violated that "simple but fundamental rule of administrative law" enunciated by this Court more than forty-five years ago in *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947):

> [A] reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis. To do so would propel the court into the domain which Congress has set aside exclusively for the administrative agency.

An important corollary to this fundamental rule is that "the courts may not accept appellate counsel's *post hoc* rationalizations for agency action. . . . [A]n agency's action must be upheld, if at all, on the basis articulated by the agency itself." *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 50 (1983). *See also American Textile Mfrs. Inst., Inc. v. Donovan*, 452 U.S. 490, 539 (1981); *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168-69 (1962).

In this case, the agency had struggled to articulate grounds for its decision. The FCC had made a first attempt at justifying its decision in its May 1992 Memorandum Opinion and Order (the *"MO&O,"* (Appendix D, App. 33a)). After SWBT had sought review of that decision and had filed its opening brief attacking various

deficiencies in the FCC's reasoning, the FCC called a halt to the proceedings and requested a voluntary remand. Its Order on Remand, seeking to justify the same ultimate result with a "clarified" explanation, followed in February 1993 ("*Order on Remand,*" (Appendix B, App. 18a)), after SWBT had filed a Petition for a Writ of Mandamus.

Together, the FCC's two decisions presented a welter of inconsistent and indefensible arguments. Chief Judge Mikva remarked during oral argument that, contrary to the court's normal expectations in granting remands requested by an agency, "I cannot recall a remand that I have ever been involved in where the agency seems to have done less to solve the problem and more to complicate the problem than this remand." Transcript of Proceedings at 25, *Southwestern Bell Telephone Co. v. FCC* (No. 93-1202). Even the FCC's appellate counsel admitted to being "mystified" by a key portion of the FCC's Order on Remand, *id.* at 23, and was unable to explain the meaning of the language of that portion of the order in a way that was consonant with the FCC's new main rationale. *Id.* at 24. Indeed, he characterized the inconsistent language as being "like the work of gremlins." *Id.*

The case on appeal should have ended there. In light of this frank admission, the court of appeals panel should have reversed and remanded the case to the FCC to consider whether its ultimate decision could indeed be lawfully and rationally justified, and, if not, whether it should finally grant SWBT the relief it is seeking.

Instead, the court of appeals crafted a rationalization for affirming the FCC that relied heavily on arguments and explanations that appeared for the first time in the FCC's appellate counsel's brief. In doing so, it violated the *Chenery* proscription and set a dangerous precedent with potentially broad repercussions.

A. The FCC's Decision Was Indefensible on Its Own Terms.

The meager and self-contradictory rationale presented in the FCC's Order on Remand was indefensible on its face. Try as it might, the FCC was unable to produce a coherent justification for flatly rejecting SWBT's tariff filing.

In its 1992 MO&O, the FCC had generally denied SWBT's request for a $65.9 million rate correction on the basis of a new "heightened scrutiny" standard it found to have been "implicitly suggest[ed]" by "policy concerns" underlying its 1990 Price Cap Order. *MO&O* at 2909 ¶ 19 (App. 43a). Dissenting Commissioner Barrett called the application of this previously unannounced new standard "patently unfair" and a matter of "deep[] concern[] . . . from both a policy and legal perspective." *Id.* at 2920 (App. 67a-68a).

SWBT challenged this decision in a brief to the court of appeals that identified numerous fatal defects in the MO&O. The FCC's retroactive application of a new standard was unlawful, and the standard itself was undefined and arbitrary and created an unlawful systematic bias. SWBT's brief also argued that the application of price cap rules governing post-January 1, 1991 tariff changes to SWBT's tariff transmittal, which was filed before January 1, would be retroactive rulemaking. Ten days before its opposing brief was due, the FCC filed a motion for voluntary remand, stating that remand would "permit the FCC to give further consideration to the matters addressed in the Commission's orders, including the ultimate resolution of this case." Motion for Remand, *Southwestern Bell Telephone Co. v. FCC* (No. 92-1220).

Following remand, but only after SWBT had filed a Petition for Writ of Mandamus, the FCC issued its Order on Remand. Its second attempt to rationalize the same ultimate resolution of the case was no more defensible

than its first. Rather than completely disavowing its earlier "heightened scrutiny" explanation, the FCC's Order on Remand "clarif[ied]" its earlier decision by demoting that rationale to "an alternate ground." *Order on Remand* at 2263 ¶ 12 (App. 25a-26a). As its new primary rationale, the now two-member majority switched to an assertion that SWBT's tariff filing had been rejected "as patently unlawful for failing to comply with applicable price cap requirements." *Id.* at 2262 ¶ 6 (App. 21a). As to the question of whether LECs could reasonably have known that those requirements would be applicable to pre-1991 mid-course corrections such as SWBT's, the FCC made only the conclusory and unsupported statement that "given the text of the *LEC Price Cap Order* and the timing of the Transmittal 2051 filing, we find Southwestern had adequate notice . . . ." *Id.* at 2263 ¶ 11 (App. 25a).

FCC Commissioner Barrett again issued a strong dissent, complaining that the majority still had not addressed the question whether the Commission had provided adequate prior notice of its new interpretation of the price cap rules. He went on to state: "I believe it important that the Commission speaks in a clear and consistent manner. It has not done so in this case. Accordingly, I must continue to dissent. Perhaps, the Court can convince the Commission to address this issue." *Id.* at 2266 (App. 30a).

SWBT's brief on review of this second rationalization demonstrated that the FCC's new primary rationale was also indefensible. SWBT's tariff filing had requested a correction of its rates that would be used to set the *starting point* for its price cap rates commencing in January 1991, not an increase of its price cap rates under the new adjustment mechanisms that applied after January 1. The critical distinction between starting point corrections and post-operational adjustments had been recognized by the FCC in its Price Cap Order, and the FCC explicitly recognized this fact in both its 1992 MO&O and its 1993 Order on

Remand. *MO&O* at 2908-09 ¶ 19 (App. 42a-43a); *Order on Remand* at 2263 ¶ 14 (App. 26a-27a). SWBT's brief also demonstrated that much of the language of the Price Cap Order, as well as the FCC's action in granting a portion of SWBT's same mid-course correction filing and the FCC's own subsequent interpretations of the Price Cap Order language, were irreconcilably inconsistent with the FCC's newest rationale for continuing to reject SWBT's filing.

FCC counsel's opposing brief raised, for the first time, an argument that notice of the preclusive effect of the Price Cap Order was contained in a single paragraph of that order, Paragraph 245. Indeed, counsel's brief quoted Paragraph 245 twice and cited or referred to it on virtually every page of the relevant argument section. *See* Brief for Respondents at 5, 10, 17, 18, 19, 20, 21, 22, 23, 24, 26, 27, *Southwestern Bell Telephone Co. v. FCC* (No. 93-1202). But Paragraph 245 was never discussed by the Commission itself in the Order on Remand, and was only cited as part of two string citations buried in footnotes. *Order on Remand* at 2261 n.4, 2263 n.16 (App. 19a-20a, 26a). The FCC had, however, explained the meaning of Paragraph 245 in its 1992 MO&O, and that explanation was precisely the opposite of FCC counsel's new interpretation:

> Specifically, the [Price Cap] Order acknowledged that mid-course corrections to July 1, 1990 rates could be filed. [citing Paragraph 245]. Acceptance of such a filing would result in an upward adjustment to the price cap so that rates, instead of being above the cap, would be at the cap.

MO&O at 2908 ¶ 19 (App. 42a-43a). Indeed, the FCC baldly admitted the same point (without citing Paragraph 245) in its Order on Remand:

> [I]f the July 1, 1990, rates subsequently proved to be unrealistically low, the *LEC Price Cap Order* left open the possibility that LECs could file mid-course

> corrections that would increase their July 1990 rates not only during the period prior to price cap tariffs becoming effective but also thereafter.

Order on Remand at 2263 ¶ 14 (App. 27a).[1]

Given these concessions, the FCC's holding that the Price Cap Order flatly barred the filing of mid-course correction filings to adjust the price cap starting point was simply untenable. Numerous portions of the Price Cap Order, as well as other actions of the FCC and the language of its own decisions, were likewise irreconcilable with the FCC's newest rationale.

Nonetheless, the court of appeals adopted counsel's rationalization and affirmed the FCC's decision on a basis upon which the Commission itself had not relied. *See Southwestern Bell Telephone Co. v. FCC*, 10 F.3d 892, 897-98 (D.C. Cir. 1993) (App. A, 10a-12a). Like FCC counsel's brief, the court's opinion relied heavily on Paragraph 245, quoting it twice and citing and referring to it repeatedly. *Id.* at 897, 898, 899 (App. 10a, 13a, 14a). Unlike the FCC's own decisions, the court's opinion wove together this new reading of Paragraph 245 with other Price Cap Order references never cited in the Order on Remand to create a rationalization that allowed the FCC's ultimate conclusion to stand. In doing so, the court explained that the FCC's concession of SWBT's position in Paragraph 14 of the Order on Remand, which the court characterized as "admittedly opaque," "superficially contradictory," "confusing," "impenetrable," and "imprecise," was nonetheless insufficient to require reversal because of the "relative clarity" of the Price Cap Order, *id.* at 899 (App. 16a), presumably referring to its analysis centering on Paragraph 245. The court did not, however, even allude to—much less satisfactorily reconcile—the fact

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[1] It was this very sentence, an obvious concession of SWBT's central argument, that appellate counsel found "mystifying" and "the work of gremlins."

that the only time the FCC itself described the import of Paragraph 245, it referred to it as meaning the opposite of what appellate counsel and the court ultimately asserted. *See MO&O* at 2908 ¶ 19 (App. 42a-43a).

B. The Court's Adoption of this *Post Hoc* Rationalization Substitutes the Court's Assessment of Policy Considerations for the Judgment of the Expert Agency Itself.

The rationalization developed by the court of appeals to affirm the FCC's decision reflected its own balancing of policy considerations, which should have been left to the FCC in the first instance. The court should at the least have remanded the case to the FCC for a careful reconciliation of the conflicting and contradictory policy statements the FCC had previously made. If the FCC were unable rationally to reconcile those statements, as SWBT believes would be the case, then the FCC would have been required to accept SWBT's tariff filings. But for the court to have taken upon itself the reconciliation of the FCC's conflicting policy statements was to usurp the statutory responsibilities of the agency, contrary to the rule of *SEC v. Chenery Corp.*

In affirming the FCC's decision, the court emphasized its view that the FCC's policy objective of preventing LECs from engaging in pre-price cap "maneuvering" and "manipulation" of their costs justified its later preclusive interpretation of the Price Cap Order. 10 F.3d at 897 (App. 10a). The court said that the FCC's apprehension about improper cost increases led it to impose "more rigorous hurdles," and hence rendered the language of the Price Cap Order adequate notice that the FCC had altogether abandoned the mid-course correction system, even for starting point corrections, and replaced it with the three narrowly constrained price cap adjustment mechanisms. 10 F.3d at 897 (App. 12a). But the FCC itself had only offered these concerns to justify a "heightened scrutiny"

standard under rate of return analysis, *Order on Remand* at 2263 (App. 26a-27a), which appellate counsel found impossible to defend, *see* Transcript of Proceedings at 23-25, *Southwestern Bell Telephone Co. v. FCC* (No. 93-1202), and the court declined to consider. 10 F.3d at 899-900 (App. 16a-17a).

Indeed, the FCC's first decision, which relied primarily on its later demoted "heightened scrutiny" rationale, had prominently featured graphs purporting to show what it characterized as a "large and unexplained increase" in SWBT's expenses for the fourth quarter of 1990, on which SWBT's mid-course correction request had been based. *MO&O* at 2909 ¶ 22, Appendices A, B-1, B-2 (App. 46a, 62a, 63a, 64a). SWBT pointed out in its brief challenging that decision, however, that the graphs misrepresented SWBT's cost justification for the rate increase it requested, since they included substantial one-time expenses that SWBT had expressly omitted in its tariff transmittal. Having been caught red-handed, the FCC, in its Order on Remand, no longer asserted that SWBT's pre-price cap costs were suspect or unjustified, and disavowed any reliance on the misleading graphs. *Order on Remand* at 2264 n.22 (App. 28a). In the complete absence of any indication that SWBT's filings reflected any "maneuvering" or "manipulation" of its costs, the court should have remanded the case to the FCC. Instead, it raised the abstract anticipation of such manipulation to a justification, which the FCC itself never relied upon, for the premature application of price cap rules.

In the Price Cap Order itself, the FCC enunciated its objectives of both avoiding unjustified rate increases and making any corrections necessary to assure the accuracy of the price cap starting point rates. It later conceded, in Paragraph 19 of the MO&O and Paragraph 14 of the Order on Remand, quoted above, that filings such as SWBT's would be considered on their merits. It nonetheless concluded in its Order on Remand that the price

cap rules absolutely barred SWBT's filing. For the court to have rationalized that self-contradictory decision by purporting to reconcile it with the FCC's policy concerns violated the fundamental precept of *SEC v. Chenery Corp.*[2] *See also, e.g., FPC v. United Gas Pipe Line Co.*, 393 U.S. 71, 73 (1968) (*per curiam*).

II. REVERSING THE COURT OF APPEALS WILL SERVE IMPORTANT FEDERAL INTERESTS.

Certiorari is also warranted because of the importance of the interests at stake in the case. The financial impact of the FCC's unlawful rejection of SWBT's tariff filing will exceed $200 million over the course of the first four-year price cap tariff period.[3] Beyond this substantial financial impact, the decision, if allowed to stand, will potentially affect a broad range of federal regulatory interests.

First, the clear message of the court's decision is that an agency need not provide unambiguous prior notice of newly adopted preclusive rules. The FCC, at least, will understand that it need provide no better than "opaque, . . . contradictory, . . . confusing, . . . impenetrable, imprecise" explanations when it chooses to interpret a prior

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[2] In order to reach this result, the court's opinion also ignored the distinction between starting-point corrections and post-operational price cap rate adjustments, *see* 10 F.3d at 893, 896-900 (App. 3a, 9a-16a), and adopted the FCC's appellate brief's rationale for distinguishing the partial relief the FCC had granted SWBT. *Id.* at 899 (App. 14a).

[3] SWBT had requested a correction of its rates that would have increased its access charge revenues by approximately $65.9 million per year. The FCC granted approximately $6.87 million of this requested relief. The shortfall of nearly $59 million per year was reflected in a reduction of SWBT's revenues for each of the first four years of the price cap regime. The FCC has recently commenced a review of the price cap system in order to consider any modifications that might be necessary beginning in 1995, but may choose not to rectify the structural deficiency, thus extending the cumulative financial impact on SWBT indefinitely.

decision in a new way. As the case stands for the proposition that the court of appeals and appellate counsel for the agency will smooth over the inconsistencies and self-contradictions of an agency's failed rationalizations, the role of the court in enforcing the Due Process and Administrative Procedure Act requirements of reasoned decisionmaking will significantly diminish. *Cf. NLRB v. Brown*, 380 U.S. 278, 290-92 (1965).

The pernicious effect of such a state of affairs is especially strong where, as here, the failed agency rationalization had to do with the clarity of its rules for accomplishing a transition to a new regulatory regime. It is in such a context that unambiguous notice of the potentially preclusive effect of new rules is particularly important, and the vigilance of the reviewing court in assuring that adversely affected parties have received due process is so necessary. Here, the court of appeals, after two utterly irreconcilable agency attempts to justify its preclusive interpretation of what was at best ambiguous and self-contradictory language in the Price Cap Order, provided the rationale that allowed the FCC to persist in an unjustifiable result. As more federal agencies consider plans to "reinvent government," the decision, if allowed to stand, will establish a dangerously low standard against which the quality and fairness of transitions to new regulatory regimes will be measured.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

MARTIN E. GRAMBOW
Southwestern Bell Corporation
—Washington, D.C.
1401 I Street, N.W., Suite 1100
Washington, D.C. 20005
(202) 326-8868

JAMES E. TAYLOR
RICHARD C. HARTGROVE
THOMAS A. PAJDA
Southwestern Bell Telephone Company
One Bell Center, Room 3520
St. Louis, Missouri 63101
(314) 235-2507

JOHN I. STEWART, JR.*
ROBERT M. HALPERIN
STEPHEN M. BYERS
CROWELL & MORING
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2595
(202) 624-2500

March 17, 1994

* *Counsel of Record for the Petitioner*

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued November 9, 1993 Decided December 17, 1993

No. 93-1202

SOUTHWESTERN BELL TELEPHONE COMPANY,
Petitioner

v.

FEDERAL COMMUNICATIONS COMMISSION;
UNITED STATES OF AMERICA,
Respondents

MCI TELECOMMUNICATIONS CORPORATION;
AMERICAN TELEPHONE AND TELEGRAPH COMPANY,
Intervenors

Petition for Review of an Order of the
Federal Communications Commission

John I. Stewart, Jr., argued the cause for petitioner. With him on the briefs were *Jennifer N. Waters, Martin E. Grambow, James E. Taylor, Richard C. Hartgrove* and *Thomas A. Pajda.*

John E. Ingle, Deputy Associate General Counsel, Federal Communications Commission, argued the cause for respondents. With him on the brief were *Renee Licht*, Acting General Counsel, Federal Communications Commission, *Daniel M. Armstrong*, Associate General Coun-

sel, Federal Communications Commission, and *James M. Carr*, Counsel, Federal Communications Commission, *Anne K. Bingaman*, Assistant Attorney General, United States Department of Justice, *Catherine G. O'Sullivan* and *Robert J. Wiggers*, Attorneys, United States Department of Justice.

Frank W. Krogh and *Donald J. Elardo* entered appearances for intervenor MCI Telecommunications Corporation.

Marc E. Manly entered an appearance for intervenor American Telephone and Telegraph Company.

Before MIKVA, *Chief Judge*, WALD and GINSBURG, *Circuit Judges*.

Opinion for the Court filed by *Circuit Judge* WALD.

WALD, *Circuit Judge:* On October 4, 1990, the Federal Communications Commission ("FCC" or "Commission") released its *LEC Price Cap Order*, 5 F.C.C. Rcd. 6786, which ushered in a new era in the regulation of major local exchange telephone carriers ("LECs"). Unlike the prior rate-of-return scheme, under which LECs were allowed to recover costs plus a designated rate of return, the price cap system, which took effect on January 1, 1991, set a rate ceiling for "baskets" of LEC services based on July 1, 1990 historical rates in order to encourage greater efficiency and to provide LECs incentives to cut costs. Southwestern Bell Telephone Company ("Southwestern"), an LEC subject to the new order, submitted a mid-course correction filing[1] to the FCC on December 4, 1990 to adjust its July 1, 1990 rate upward

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[1] The term "mid-course correction filing" generally refers to an LEC's proposed rate adjustment to account for actual costs experienced under rate-of-return regulation that deviate from cost projections employed in initial rate-setting proceedings. As described below, the FCC appears also to use "mid-course correction filing" more broadly to refer to any mid-stream rate adjustment, whether under rate-of-return or price cap regulations.

to account for actual costs experienced between July and November. After a lengthy process below involving two opinions and a voluntary remand order, the FCC rejected Southwestern's mid-course correction filing on the grounds that the mid-course mechanism that had prevailed under rate-of-return regulation had been supplanted by three different mechanisms for raising prices under the price cap rules, and that Southwestern had not met the particular procedural hurdles required by any of the three. The FCC also noted that, even if the former type of mid-course corrections were permissible under the new order, such filings would be reviewed under much more stringent criteria than had obtained under rate-of-return regulation—a level of review that Southwestern had also failed to satisfy in this instance.

Southwestern petitioned this court for relief, contending that the price cap order provided insufficient notice that mid-course corrections to adjust the July 1, 1990 starting points would be analyzed pursuant to a higher standard or barred altogether. We agree with Southwestern that the Commission has been less than a beacon of clarity. Nonetheless, we conclude that the price cap order, fairly read, provided sufficient notice to alert LECs that increases to the July 1, 1990 price cap that were to go into effect after January 1, 1991 could be accomplished only through the three mechanisms set forth in the order. Because we find that the order provided adequate notice of the Commission's principal contention below, we deny Southwestern's petition for review.

I. Background

A. *Regulatory Context*

The Communications Act of 1934 requires the FCC to regulate the rates a carrier may charge for interstate telecommunications service. *See* 47 U.S.C. §§ 201-205 (1988). Until 1991, the FCC employed rate-of-return regulation in setting rates for LECs. Under the rate-of-

return scheme, carriers calculated rates so that projected revenues would cover projected operating expenses plus a designated return set by the FCC. The FCC required LECs to file annual tariff filings that included actual cost and revenue data for the preceding year, projections of costs and revenues for the upcoming year, and proposed rates that would attain but not exceed the authorized rate of return. *See* 47 C.F.R. § 61.38 (1992). LECs bore the burden of proving proposed rates just and reasonable. *See* 47 U.S.C. § 204(a)(1) (1988). In the event that an LEC's projections proved to be too high or too low during the course of the rate year, the FCC provided for mid-course corrections to make appropriate adjustments. *See* 47 C.F.R. § 69.3(b) (1992). These mid-course filings were also evaluated according to the just and reasonable standard. *See Virgin Islands Tele. Corp.*, 6 F.C.C. Rcd. 7350, 7351 (1991), *rev'd on other grounds, Virgin Islands Tele. Corp. v. FCC*, 989 F.2d 1231 (D.C. Cir. 1993).

Because of the indeterminacy of figures used in rate projections, carriers "virtually never" earned precisely their authorized rate of return under rate-of-return regulation. *AT & T v. FCC*, 836 F.2d 1386, 1388 (D.C. Cir. 1988); *accord Virgin Islands Tele. Corp.*, 989 F.2d at 1233. Nonetheless, the FCC's mid-course correction mechanism provided a safeguard that alleviated some of the unavoidable imprecision. *See id.* By allowing upward adjustments in rates to account for actual costs, the FCC ensured that LEC rates would not dip far below that level necessary to achieve the authorized rate of return. Thus, we recognized in *AT & T* that "the gap between the actual return and the projected return may more often than not be relatively small." 836 F.2d at 1388.

On October 4, 1990, after years of debate and revision, the FCC released its *LEC Price Cap Order*, which fundamentally altered the system of regulating the eight major LECs. *See* 5 F.C.C. Rcd. 6786. Slated to go into effect

on January 1, 1991, the Order replaced rate-of-return regulation with an incentive-based price cap regime designed to simulate market competition. The FCC devised the price cap order to rectify the perceived failing of rate-of-return regulation, which provided no incentive for LECs to become more efficient and productive. To set into motion the appropriate incentives, the price cap order "basketized" LEC services and limited the amount LECs could charge for these services to a fixed historical rate. The FCC reasoned that setting a price cap would exert a downward pressure on costs, catalyzing LECs to develop technological and administrative innovations in an effort to secure a more favorable rate of return. Recognizing that LECs would have every incentive to exaggerate costs to boost their initial price caps if the price cap were set prospectively, the FCC adopted a historical rate that, while concededly not perfect, represented "the best that rate of return regulation can produce." 5 F.C.C. Rcd. at 6814 (¶ 232). Accordingly, the FCC mandated that the starting point for price cap regulation would be those rates that the FCC had approved on July 1, 1990, subject to a minor downward adjustment in the allowable rate of return mandated in a companion order.

Under the price cap regime, the FCC accords a presumption of lawfulness to interstate rates falling at or below a price cap and within specified pricing bands for baskets of services.[2] The rules authorize three separate mechanisms by which LECs can obtain an upward adjustment of the price cap. The first, a low-end adjustment mechanism, results in an automatic increase to the price cap should an LEC's earnings drop below a 10.25% rate of return. *See* 5 F.C.C. Rcd. at 6788 (¶ 10); 47 C.F.R. § 61.45(d)(1)(vii). The second, an exogenous cost mechanism, allows adjustments to the price cap for cer-

[2] In *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993), we upheld the price cap order's "baskets," profit-sharing mechanisms, and streamlined tariff review procedures for below-cap filings against a substantive APA challenge.

tain enumerated costs that are beyond the control of carriers—for example, costs incurred by changes in the accounting methods mandated by the FCC. *See* 5 F.C.C. Rcd. at 6807-10 (¶¶ 166-190); 47 C.F.R. § 61.45(d)(1). The third, an above-cap filing, allows LECs to set rates higher than the price caps if they submit extensive support materials demonstrating that, despite the low-end adjustment mechanism and opportunities to increase efficiency, their particular price cap nonetheless renders them unable to attract capital and to continue to operate. *See* 5 F.C.C. Rcd. at 6823-24 (¶¶ 300-304); 47 C.F.R. § 61.49(e).

B. *Procedural History*

In accordance with then-prevailing rate-of-return regulations, Southwestern made a rate filing in April 1990 based on projected data for the tariff period between July 1990 and June 1991. The Common Carrier Bureau of the FCC ("CCB") permitted the LEC's proposed rates to go into effect on July 1, 1990, subject to disallowance of certain forecasted costs. On October 4, 1990, the FCC issued the *LEC Price Cap Order,* which required initial price cap tariff filings to be made on November 1, 1990. Southwestern complied, proposing rates that fell within its July 1, 1990 price cap.

On November 26, 1990, Southwestern determined to submit a mid-course correction filing to the FCC in order to increase its July 1, 1990 starting point to account for actual costs and revenues experienced between July and November. Southwestern applied for and received a waiver of § 61.38(b)(1) of the Commission's regulations, which specifies the supporting information that must accompany a filing. The CCB emphasized that the waiver did not constitute approval of the underlying filing or prejudice any subsequent action that the Commission might undertake. *See* Letter from John Cimko, Chief of FCC's Tariff Division, to William A. Blase, Jr., Southwestern, Nov. 29, 1990, ***reprinted in*** Joint Appendix

("J.A.") at 4. The Commission declined to waive 47 C.F.R. § 61.58, which requires advance notice of forty-five days before a tariff filing may become effective. On December 4, 1990, Southwestern submitted its proposed tariff revision to the FCC. Pursuant to § 61.58, the proposed increase could take effect no earlier than January 18, 1991, two weeks after the commencement of the price cap regulations. While this application was pending, Southwestern made a supplemental filing on March 22, 1991 that sought to introduce additional data to justify an even larger rate increase than initially proposed.

In its order of April 9, 1991, the CCB rejected Southwestern's mid-course filings on the grounds that they were barred by the new price cap rules. *See Southwestern Bell Telephone Co.*, 6 F.C.C. Rcd. 2089 (Comm. Car. Bur. 1991). The CCB reasoned that the price cap order "[did] not suggest that the Commission expected to adjust the July 1 rates to fine tune rates to the authorized [rate-of-return] level." *Id.* at 2091 (¶ 20). Because Southwestern's additional costs did not qualify as exogenous under the price cap rules, the CCB determined that Southwestern's submissions constituted impermissible above-cap filings. The CCB noted further that, due to inadequate data, Southwestern's filings would also have been rejected under the prior rate-of-return regime. *See id.* (¶ 22).

On May 6, 1992, the full Commission, one member dissenting, issued a memorandum opinion affirming the CCB's decision. *See Southwestern Bell Telephone Co.*, 7 F.C.C. Rcd. 2906 (1992). The Commission acknowledged that the price cap order left open the possibility of filing mid-course corrections to increase the initial price cap prior to the commencement of the price cap system, but stated that the order provided for a heightened scrutiny of any such filings that Southwestern could not satisfy in this instance. The Commission bolstered its conclusion rejecting the bulk of Southwestern's filing by noting that

the tariff revisions were not scheduled to become effective until after the change-over to price cap regulation. *See id.* at 2910 (¶ 29). The FCC observed that Southwestern had failed to comply with the three mechanisms included in the price cap order for increases to the price cap. Despite these conclusions, the Commission ordered an upward adjustment to the price cap base rates of $6.87 million to account for anomalous data from 1986 that had erroneously been included in calculating Southwestern's growth rate in the July 1, 1990 rate-setting proceeding. *See id.* ¶¶ 25-26).

On May 18, 1992, Southwestern petitioned this court for review of the Commission's order. After receiving Southwestern's opening brief, the FCC moved for voluntary remand of the case in order "to permit the FCC to give further consideration to the matters addressed in the Commission's orders, including the ultimate resolution of this case." J.A. 566. We granted the FCC's motion to remand the case in an order of October 30, 1992. The FCC released its order on remand on March 10, 1993.

In its remand order, the Commission "reaffirm[ed] its essential holding." *Southwestern Bell Telephone Co.*, 8 F.C.C. Rcd. 2261 (1993). The FCC found that Southwestern's mid-course correction filing, which could take effect no earlier than January 18, 1991, was clearly subject to the price cap order. Because Southwestern had not complied with the requirements for any of the three upward adjustment mechanisms set forth in the price cap order, the FCC rejected its filing as patently unlawful. As an "alternate ground" for its decision, the Commission determined that, even if rate-of-return rules applied, the price order evinced the FCC's intention to evaluate mid-course filings under a more rigorous standard than had obtained prior to the order. *Id.* at 2263 (¶ 12). The FCC cited an endnote in the order for the proposition that such filings would not face "routine" treatment. *Id.* (¶ 16) (citing *LEC Price Cap Order*, 5 F.C.C. Rcd.

at 6848 n.315). Because Southwestern had not satisfied these more stringent criteria, the FCC determined that the filing had been properly rejected even under rate-of-return rules. Southwestern filed a timely petition for review with this court.

II. Analysis

The principal issue before us in this case is whether the FCC provided Southwestern sufficient notice in the price cap order that mid-course filings would either be barred outright in lieu of the three prescribed price-cap mechanisms or evaluated pursuant to some more rigorous standard.[3] This court most recently addressed the issue of adequate notice in *McElroy Electronics Corp. v. FCC*, 990 F.2d 1351 (D.C. Cir. 1993), in which we held that elementary fairness requires "not . . . that the agency have made the clearest possible articulation," but "only that, based on a 'fair reading' of its order, the petitioners knew or should have known what the Commission expected of them." *Id.* at 1358 (citing *RCA Global Communications, Inc. v. FCC*, 758 F.2d 722, 730-31 (D.C. Cir. 1985)). The key factor for our purposes is that the order be "reasonably comprehensible to [people] acting in good faith." *Maxcell Telecom Plus, Inc. v. FCC*, 815 F.2d 1551, 1558 (D.C. Cir. 1987) (quoting *Bamford v. FCC*, 535 F.2d 78, 82 (D.C. Cir.), *cert. denied*, 429 U.S. 895 (1976)). As we underscored in *McElroy Electronics* and reiterate here, we do not examine the reasonableness of the Commission's intended interpretation, but simply evaluate "the clarity with which the agency made that intent known." 990 F.2d at 1358. Although the agency's interpretation of its own orders is ordinarily entitled to deference, we pay strict heed to whether the agency provided affected parties with full notice of the *content* of

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[3] Southwestern concedes that it did not comply with the requirements of the three price cap mechanisms.

those interpretations. *See Satellite Broadcasting Co. v. FCC*, 824 F.2d 1, 4 (D.C. Cir. 1987).

A. *The FCC's Central Argument*

The FCC's primary rationale in its remand order for rejecting Southwestern's mid-course filing is that the *LEC Price Cap Order* provides the exclusive mechanisms by which the price cap may be increased after January 1, 1991. Southwestern urges that the FCC provided no prior notice of its intent to supplant the traditional mid-course correction process with the more narrowly circumscribed procedures for raising prices set forth in the price cap order. Southwestern contends further that the FCC's original order relying on heightened scrutiny for mid-course correction filings as its basis for rejecting Southwestern's filing demonstrates that the Commission itself could not find clear notice in the order for its current position. After careful review, we find ample support for the proposition that the price cap rules set forth the exclusive mechanisms for raising price caps to account for actual costs after January 1, 1991. Because the order clearly supports the FCC's primary rationale below, we reject Southwestern's notice challenge.

The text of the price cap order patently reflects both the FCC's intention to insulate the initial price caps from carrier manipulation and the FCC's recognition that its new regulatory scheme creates tremendous incentives for carriers to engage in base-rate maneuvering. At ¶ 230 of the order, the FCC mandates that "LEC interstate access rates, as they existed on July 1, 1990 and were adjusted by an Erratum, are the most reasonable basis from which to launch a system of price cap regulation." 5 F.C.C. Rcd. at 6814. The FCC notes at ¶ 232 that these rates, "while perhaps not perfect, in general represent the best that rate of return regulation can produce." *Id.* At ¶ 245, the FCC explains that initial price caps are set at historical levels to "prevent[] LECs subject to price caps

from engaging in a rapid escalation in prices that would have the effect of raising their price cap base rates." *Id.* at 6816. Moreover, the FCC indicates in the same section that LECs may not adjust the initial price caps: "Since the elements of the [price cap] are *outside the control of the carriers*, and *do not depend on actual prices*, the price cap that LECs must adhere to on January 1, 1991 will not increase should a LEC attempt to raise prices in the interim." *Id.* (emphasis added). The order provides that the FCC was "not making a finding that existing rates are just and reasonable, but only that they are a *reasonable starting point* for price caps. . . ." *Id.* at 6816 (¶ 241) (emphasis added). The order reasons that a broad rate-of-return proceeding aimed at identifying possible deficiencies in existing rates prior to the commencement of the price cap rules would only serve to "delay . . . the introduction of more economically efficient rates." *Id.* (¶ 243). Finally, at ¶ 189, the order rejects a proposal to allow automatic flow-through of all "extraordinary costs," reasoning that "a carrier's ability to cope with unforeseen events, yet remain competitive, is in part a function of its engineering, investment and operational decisions." *Id.* at 6809.

Cumulatively, these excerpts make abundantly clear the FCC's intention to abandon ordinary mid-course corrections under its new price cap regime. In the order, the FCC acknowledges the likelihood that rational LECs, like Southwestern, would be motivated to elevate their costs to obtain the highest possible price cap if price caps were set prospectively. The FCC repeatedly emphasizes that it adopted historical rates to avoid the possibility of just such manipulation. And the FCC carefully explains that, although the July 1, 1990 rates were by no means perfect, they could serve as reasonable points of departure. Repeated emphasis on the historical basis for the price cap rates and admonitions that the LECs would not henceforth be allowed to adjust the initial price cap to account for actual costs undercuts any conclusion that

the FCC intended the old rate-of-return "perfecting" process to continue unabated. In its conclusion that "extraordinary costs" should not automatically translate into higher rates, the Commission manifests its clear intent that more rigorous hurdles awaited any attempt to raise prices that might potentially frustrate incentives for efficiency.

The detailed provision of three mechanisms incorporating these more rigorous hurdles reinforces our conclusion that Southwestern's position is without support in the order. These mechanisms demonstrate that the Commission was, in fact, solicitous of the argument that an unduly low price cap might translate into confiscatory rates. The procedures set forth in the order appear to balance carefully the competing considerations of efficiency and fairness, allowing LECs to charge rates in excess of the cap if no amount of intraoperation shuffling will yield a reasonable rate of return. Thus, the low-end adjustment mechanism prevents LECs from dropping below a 10.25% rate of return. *See* 5 F.C.C. Rcd. at 6788 (¶ 10); 47 C.F.R. § 61.45(d)(1)(vii). The exogenous cost mechanism allows automatic adjustments to the price cap for certain extraordinary costs that are beyond the control of carriers. *See* 5 F.C.C. Rcd. at 6807-10 (¶¶ 166-190); 47 C.F.R. § 61.45(d)(1). Finally, the above-cap filing mechanism permits LECs to set rates higher than the price caps if they submit particular data demonstrating that they face the threat of discontinued operations. *See* 5 F.C.C. Rcd. at 6823-24 (¶¶ 300-304); 47 C.F.R. § 61.49(e). That the FCC sets forth three precise, albeit more limited, methods for accommodating adverse economic conditions bolsters our reading that the price cap order intended to abandon the more lenient mid-course correction system; the three new methods signify the FCC's determination that the "fairly wide latitude" in cost recovery afforded LECs under rate-of-return regulation, *see* 5 F.C.C. Rcd. at 6789 (¶ 22), could put at risk its incentive-based scheme.

As Southwestern indicates, the price cap order does make reference to mid-course corrections. However, we do not believe that the isolated instances in which that term appears undercut our conclusion that the order gave adequate notice that traditional mid-course corrections would cease after January 1, 1991. The price cap order provides that, "[d]uring the period between the July 1, 1990 date . . . and the January 1, 1991 start date of price cap regulation, LECs remain free to introduce new effective prices justified under existing rate of return cost support requirements." *Id.* at 6816 (¶ 245). Rather than support Southwestern's argument, we find this statement undermines it, because the sentence is immediately followed by an avowal that

> [t]o the extent LEC transmittals have the effect of increasing prices for services during this six month period, our decision to inaugurate the price cap index (PCI) on July 1, 1990 and to require actual prices to be equal to or below the PCI on January 1, 1991, prevents LECs subject to price caps from engaging in a rapid escalation in prices that would have the effect of raising their price cap base rates.

Id. Thus, although it is true that the price cap order may leave open a six-month window prior to January 1, 1991 for routine mid-course corrections, it is also clear by the terms of this order that the Commission did not contemplate that any rate increases occurring during this period would automatically raise the actual price cap for the purposes of the new regulations. Footnote 315 of the order, the meaning of which the parties vigorously dispute, provides in full that

> In the *Supplemental Notice*, we proposed that any retargeting resulting from over- or under-earnings be treated as exogenous during the six months leading up to price caps. However, since we decided to conduct a full access filing for July 1, 1990, mid-course corrections during the six-month period leading up

> to price caps are likely to be premature. We will not give any such corrections routine exogenous treatment.

5 F.C.C. Rcd. at 6848 n.315. To the extent the FCC made reference to mid-course corrections in this footnote, its reference is obscure and certainly does not clearly evidence any "business as usual" intent on the part of the Commission with respect to the use of the mid-course correction mechanism to adjust price caps. Frankly, we do not understand the import of this language, but in any case, buried as it is amid pages of endnotes, it cannot have the effect of signalling an intent to preserve the mid-course correction status quo contrary to the basic thrust of the text of the order. *See McElroy Electronics Corp. v. FCC*, 990 F.2d 1351, 1362 (D.C. Cir. 1993) (rejecting FCC's attempt to convert single footnote into a beacon).

Southwestern also argues that the FCC's decision to adjust the price cap upward by $6.87 million to account for anomalous 1986 data used in forecasting, *see Order on Remand*, 8 F.C.C. Rcd. at 2261(¶ 5), belies the Commission's argument that the price cap rules provided the exclusive means by which to raise the price cap. We agree that the $6.87 million adjustment was not made pursuant to any of the enumerated price cap mechanisms. However, for purposes of interpreting the price cap order, we see a crucial distinction between adjustments based on erroneous historical data and adjustments based on actual costs. The price cap order expressly disavows the view that the starting points must reflect actual costs. *See* 5 F.C.C. Rcd. at 6816 (¶ 245). The order erects rigorous mechanisms for increasing the price cap, overriding the more liberal mid-course correction mechanism, in order to forestall strategic behavior on the part of LECs anxious to obtain a little breathing room. However, in Southwestern's case, the FCC provided an adjustment for historical, not actual costs. The adjust-

ment for pre-July 1, 1990 errors so as to ensure that the July 1, 1990 rate-setting was itself conducted correctly seems to us consistent with the order.[4]

Southwestern's final, and perhaps most significant, argument revolves around one sentence in the FCC's remand order. In its section setting forth its alternate rationale, the FCC states that 'if the July 1, 1990 rates subsequently proved to be unrealistically low, the *LEC Price Cap Order* left open the possibility that LECs could file mid-course corrections that would increase their July 1990 rates not only during the period prior to price cap tariffs becoming effective *but also thereafter*." 8 F.C.C. Rcd. at 2263 (¶ 14) (emphasis added). Although this single sentence might indeed suggest that the order permitted *ordinary* mid-course corrections to raise the price cap, the paragraphs that follow retract that suggestion by announcing that the FCC considered but ultimately abandoned its original proposal to treat actual costs as *routine exogenous factors* under the price cap rules. Taken in context, the FCC's reference to mid-course corrections in this section, while admittedly opaque and even superficially contradictory, seems nonetheless most reasonably

[4] In connection with this argument, Southwestern also contends that the FCC perpetrated systematic bias by allowing price cap adjustments *downward* without adhering to the three price cap mechanisms prescribed by the order when investigations revealed the price caps to be unlawfully high. Southwestern cites to our opinion in *AT & T v. FCC*, 836 F.2d 1386 (D.C. Cir. 1988), for support. *AT & T* rejected total asymmetry in the Commission's refund rules, which required refunds for utility earnings above the prescribed rate of return but did not allow *any* method of recovering for shortfalls. We fail to see any analogous evidence of "systematic bias" in the FCC's order. The FCC devised its scheme cognizant of the tremendous incentives facing LECs to inflate their price caps. If price caps were set too high, the FCC reasoned, LECs would have little impetus to streamline their operations. Absent any indication that increases were barred altogether, we do not see any objectionable bias in the FCC's effort to erect more rigorous hurdles for LECs intent on raising their price caps in order to safeguard the objectives of its new regulatory regime.

directed to the escape mechanisms of the new price cap scheme. Its use of key price cap language, "unrealistically low" and "exogenous costs," is more attuned to the new scheme's mechanisms than to the old. It is only the use of the old term of art "mid-course correction" that introduces the confusing note—though technically, that term could apply with equal force to attempts to raise prices under the new scheme's procedures, as well. In any case, we do not see this sentence as imperilling our central conclusion. Obviously, the FCC courts danger when it uses impenetrable, imprecise language. In this particular instance, however, given the relative clarity with which the price cap order itself mandates rejection of Southwestern's filing, we find insufficient cause for reversal.

Accordingly, we conclude that the *LEC Price Cap Order* adequately put LECs on notice that mid-course correction filings under traditional rate-of-return regulation would not be available to increase initial price caps after January 1, 1991. Under the clear terms of the price cap order, LECs seeking elevated starting points had to operate within the parameters of the price cap order's upward adjustment mechanisms.

B. *The FCC's Alternate Argument*

After canvassing its primary justification for rejecting Southwestern's mid-course correction filing, the FCC set forth in its remand order what it characterized as an "alternate ground" for the result. *See* 8 F.C.C. Rcd. at 2263 (¶ 12). The FCC rebutted Southwestern's contention that ordinary rate-of-return rules should apply by arguing that, even if mid-course corrections *were* feasible under the price cap order, footnote 315 notified LECs that much more rigid scrutiny of such corrections would obtain. Southwestern assails this "much more rigid scrutiny" as utterly without content. We decline to pass on the merits of the FCC's second justification, because the FCC's clear primary rationale has obvious support in the

price cap order, and it is evident that the "alternate ground" of heightened scrutiny is subordinate and offered solely to rebut specific arguments of Southwestern.

III. Conclusion

For the foregoing reasons, we deny Southwestern's petition for review of the order dismissing its mid-course correction filing for failure to comply with the price cap rules. The *LEC Price Cap Order* adequately communicates the FCC's intention to steer a new course and to evaluate attempts to raise price caps after January 1, 1991 pursuant only to the mechanisms set out in the price cap scheme itself.

It is so ordered.

APPENDIX B

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Transmittal No. 2051

IN THE MATTER OF

SOUTHWESTERN BELL TELEPHONE COMPANY
APPLICATION FOR REVIEW

MEMORANDUM OPINION AND ORDER ON REMAND

Adopted: February 19, 1993; Released: March 10, 1993

By the Commission: Commissioner Barrett concurring in part and dissenting in part and issuing a statement.

I. INTRODUCTION

1. On May 18, 1992, Southwestern Bell Telephone Company (Southwestern) filed a petition (Southwestern Petition) with the U.S. Court of Appeals for the District of Columbia Circuit (Circuit Court) seeking review of an order we released earlier that month.[1] In the *Southwestern Mid-course Order,* we granted in part and denied in part a Southwestern request for review of a Common Carrier

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[1] *Southwestern Bell Telephone Company v. FCC,* D.C. Cir. 92-1220 (*SWB v. FCC*). The petition challenged the Commission Order released May 6, 1992: Southwestern Bell Telephone Company, Transmittal No. 2051, Application for Review, 7 FCC Rcd 2906 (1992) (*Southwestern Mid-course Order*).

Bureau (Bureau) order which had rejected the above Southwestern transmittal and related filings.[2]

2. After the Southwestern Petition and supporting brief were filed, we asked the Circuit Court to remand the case to enable us to give further consideration to the *Southwestern Mid-Course Order*. On October 30, 1992, the Circuit Court granted our request. Upon further consideration of that order, we "reaffirm its essential holding. However, we take this opportunity to clarify the reasoning underlying that decision.

II. BACKGROUND

3. On May 3, 1991, Southwestern filed the above Application for Review (Southwestern Application) of the *Bureau Order*. That order rejected Southwestern's earlier Transmittal 2051[3] and related filings through which Southwestern had sought not only to increase its access rates but also, and principally, to increase its price cap indexes that establish the upper limit on Southwestern's aggregate rate levels. Through these filings, Southwestern sought to exempt itself from the requirement of the *LEC Price Cap Order* that LECs not engage in any aggregate price increases in the period leading up to price cap regulation such that any rate increases occurring between July 1 and December 31, 1990, be offset by decreases.[4] Thus, the relief sought by Southwestern in

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[2] Southwestern Bell Telephone Company, Revisions to Tariff F.C.C. No. 68, Transmittal No. 2051, 6 FCC Rcd 2089 (Com. Car. Bur. 1991) (*Bureau Order*).

[3] Southwestern Bell Telephone Company, Revisions to Tariff F.C.C. No. 68, Transmittal No. 2051 (filed Dec. 4, 1990) (Transmittal 2051). As filed, Transmittal 2051 had an effective date of January 18, 1991, which was after the effective date of price cap regulation.

[4] Second Report and Order, 5 FCC Rcd 6786, 6814-17 (paras. 230-231, 245-250) (1990) and Erratum, 5 FCC Rcd 7664 (1990) (*LEC Price Cap Order*), *modified on recon.*, 6 FCC Rcd 2637 (1991), *petitions for recon. of ONA Part 69 Order pending, peti-*

Transmittal 2051 and related filings did not merely involve a proposed increase in Southwestern's access rates but also an increase in the initial price cap indexes previously selected by this Commission for the price cap regulation of Southwestern.

4. Southwestern raised a number of objections to the *Bureau Order*. Southwestern challenged the Bureau's decision to apply price cap regulation to Southwestern's mid-course filings and its conclusion that these filings should be rejected under that regulatory scheme. Southwestern further argued that, if the Bureau had properly applied rate of return regulation, acceptance of those filings would have been required.

5. Based upon our review of the Southwestern Application and the related filings, our *Southwestern Mid-Course Order* generally affirmed the Bureau's rejection of Southwestern's request to increase its rates and price cap indexes. However, we did allow a $6.87 million technical correction to Southwestern's July 1, 1990, access rates

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tions for further recon. dismissed, 6 FCC Rcd 7482 (1991), *further modified on recon.*, 6 FCC Rcd 4524 (1991) (*ONA Part 69 Order*), *petitions for recon. of ONA Part 69 Order pending, appeal docketed, D.C. PSC v. FCC*, No. 91-1279 (D.C. Cir. June 14, 1991). In the *LEC Price Cap Order*, this Commission designated each price cap LEC's aggregate July 1, 1990, rates as the starting point for price cap regulation. By inaugurating the Price Cap Index (PCI) and the Actual Price Index (API) on the same date, and deciding that the date should be six months before the effective date of these LECs' initial price cap tariffs, the Commission sought to assure that, within each basket of services, any rate increases in one service would have to be offset by rate reductions for other services. Thus, within each basket, each LEC's aggregate January 1, 1991, rate levels were kept at or below an initial price cap set for that LEC on the basis of its rates six months earlier. These decisions ensured that in the interim between the September 1990 adoption of LEC price cap regulation and its January 1991 implementation, LECs would not be able to drive up their 1991 price caps by increasing their 1990 rates. *LEC Price Cap Order*, 5 FCC Rcd at 6814-6817 (paras. 230-231, 245-250).

and corresponding indexes.[5] In the instant Order, we clarify the *Southwestern Mid-course Order*.[6]

III. APPLICABLE STANDARD

A. Application of Price Cap Regulation

6. The Southwestern Application argued that the Bureau Order had incorrectly applied price cap regulation to Transmittal 2051, rejecting it for violation of the price cap rules. According to Southwestern, the Bureau should have examined the transmittal under rate of return rules, and permitted the transmittal to take effect. On review, the *Southwestern Mid-course Order* examined Southwestern's rate of return argument first, finding that even if rate of return rules had been applicable, Southwestern had not made the required showing. In this Order, we clarify that the fact that we addressed Southwestern's rate of return argument at length in our earlier Order should not be construed as a decision to modify or abandon the Bureau's rationale for rejecting Transmittal 2051. As discussed below, the Bureau correctly determined that the proposed revisions to Southwestern's rates and related price cap indexes would have violated the *LEC Price Cap Order* and our price cap rules.[7] Accordingly, we clarify that Southwestern Transmittal 2051 was correctly rejected as patently unlawful for failing to comply with applicable price cap requirements and we expressly affirm the Bureau's decision to reject the tariff filing.

7. The Commission released the *LEC Price Cap Order* on October 4, 1990, and the price cap rules became effective October 31, 1990.[8] On that date Southwestern

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[5] *See Southwestern Mid-course Order*, 7 FCC Rcd at 2910 (paras. 25-28).

[6] We do not revisit each and every argument addressed in the *Southwestern Mid-course Order*.

[7] *See Bureau Order*, 6 FCC Rcd at 2090.

[8] *See LEC Price Cap Order*, 5 FCC Rcd at 6837-6838 (para. 413). *See also* Policy and Rules Concerning Rates for Dominant Carriers,

and other large local exchange carriers became subject to mandatory price cap rules which set their price caps based on their July 1, 1990, aggregate rates adjusted for the change in the authorized rate of return which became effective on January 1, 1991. Those rules required Southwestern and the other price cap carriers to file their first price cap tariffs based on those July rates on November 1, 1990, with an effective date of January 1, 1991. Southwestern was subject to price cap regulation when it filed its initial price cap tariff on November 1, and continued to be subject to such regulation when, over a month later, on December 4, 1990, it filed Transmittal 2051, which it characterized as a mid-course filing, with an effective date of January 18, 1991. Accordingly, we confirm our earlier finding that the Bureau was correct in applying price cap rules to Transmittal 2051 and subsequent related filings.[9]

8. As noted in the *Southwestern Mid-course Order*, price cap regulation permits carriers to adjust their price cap indexes upward in two ways relevant here: through an above-cap filing and through an exogenous cost adjust-

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55 FR 42375 (Oct. 19, 1990). This notice in the Federal Register included a summary of the LEC price cap rules and a statement that they would become effective October 31, 1990. Subsequent corrections to these rules did not change that effective date. Erratum, 5 FCC Rcd 7664 (1990); 55 FR 50558 (Dec. 7, 1990).

[9] Our statement in the *Southwestern Mid-course Order* at paragraph 29 that Transmittal 2051 was filed while rate of return regulation still applied to Southwestern was correct in that the Southwestern rates in effect when that transmittal was filed were set with reference to rate of return regulation because Southwestern's initial price cap tariffs had not yet become effective. However, as we clarify in the instant Order, any Southwestern tariff revision, filed after the price cap rules became law on October 31, 1990, and bearing an effective date later than December 31, 1990, necessarily was subject to the price cap rules rather than rate of return regulation. Accordingly, after December 31, 1990, the extent to which the rates and other terms of such a tariff are just and reasonable could only be determined with reference to price cap regulation. *See LEC Price Cap Order* 5 FCC Rcd at 6836 (paras. 401-406).

ment.[10] To allow Southwestern to implement price cap regulation with the rates Transmittal 2051 contemplated, we would have had to permit Southwestern to increase its aggregate rates above the price cap indexes we initiated at July 1, 1990, rate levels and the subsequent represcription. Such above-cap filings can be made by price cap carriers who contend they cannot achieve the productivity gains required by price cap regulation and, therefore, that their aggregate rates must be allowed to exceed the applicable price cap.[11] Section 61.49(e) of our Rules, 47 CFR § 61.49(e), provides that such above-cap filings must be accompanied, first, by an explanation of how all costs have been allocated among the carrier's baskets and, second, within the relevant basket, the carrier must make a cost assignment showing, including a detailed explanation of the reasons for the prices of all rate elements to which costs are not assigned. In Transmittal 2051, Southwestern neither explained the manner in which its costs had been allocated among its baskets nor provided the cost assignment showing required by this rule.[12] Indeed,

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[10] The *Southwestern Mid-course Order* listed a third way—a price cap low end earnings adjustment. For a LEC that experiences unusually low earnings during a specified base period of price cap regulation, such an adjustment would be available so that the LEC could prospectively raise its PCIs and its related rates. Since the first price cap tariff year did not begin until 1991, this earnings adjustment would not be available to remedy any alleged SWB earnings shortfall until July 1992. *See* Section 61.45(d)(1)(vii) of our Rules. 47 CFR § 61.45(d)(1)(vii); *LEC Price Cap Order*, 5 FCC Rcd at 6802 (para. 127). Since our rules precluded Southwestern from using this to increase its PCI in December 1990, we do not discuss it here.

[11] *See LEC Price Cap Order*, 5 FCC Rcd at 6823-24 (paras. 300-304).

[12] This detailed cost showing is intended to discourage price cap carriers from breaching their price cap indexes, unless those indexes would lead to confiscatory rates. Should a price cap carrier experience such low earnings over such a prolonged period of time that its opportunity to attract capital and its ability to provide

Southwestern has conceded that it did not make a price cap showing required by our rules because it claimed rate of return regulation still applied. In view of these patent defects, the Bureau could not have permitted Transmittal 2051 to become effective as an above-cap filing under Section 61.49(e).

9. Alternatively, Transmittal 2051 could be regarded as an application for an exogenous cost adjustment. As indicated in the *Bureau Order*, unless Southwestern's projected revenue requirement changes qualified as a change in its exogenous costs, Southwestern's filing amounted to an unjustified above-cap filing.[13] Exogenous costs are one of three variables that determine how a given price cap index changes over time. Only a limited list of such costs are permitted to alter the price cap index. Section 61.45(d) of our rules, which lists these permissible exogenous cost adjustments, also includes cost changes caused by such other extraordinary exogenous cost changes as the Commission shall permit or require.[14] Thus, the *LEC Price Cap Order* and the Commission's rules leave open the possibility of adjusting the price cap index for exogenous costs not found on the list. However, in the *LEC Price Cap Order*, this Commission indicated that it would not permit any additional exogenous cost adjustments except in a "truly extraordinary situation" to avoid confiscatory rates.[15]

10. In Transmittal 2051, Southwestern did not seek an exogenous cost adjustment or otherwise attempt to

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service were seriously impaired, the low end adjustment mechanism would enable that carrier to raise its price cap indexes. However, as explained in note 10, *supra*, that mechanism was unavailable to Southwestern at the time it filed Transmittal 2051.

[13] *Bureau Order*, 6 FCC Rcd at 2092 n.9.

[14] *See* Section 61.45(d)(1)(vi) of the Commission's Rules, 47 CFR § 61.45(d)(1)(vi). Southwestern does not raise any of the matters included in the list.

[15] *See LEC Price Cap Order*, 5 FCC Rcd at 6810 (para. 190).

justify such an exogenous adjustment by claiming that its then current rates were confiscatory because of some truly extraordinary situation. On the contrary, Southwestern asserted that it was making an ordinary mid-course correction similar to other mid-course corrections that it and other LECs had filed in the past under rate of return regulation. Thus, to the extent Transmittal 2051 is viewed as a request for an exogenous cost adjustment, it was properly rejected as patently unlawful under Section 61.45(d) and the *LEC Price Cap Order*.

11. We therefore reaffirm the findings in the *Southwestern Mid-course Order* that the Bureau properly applied price cap rather than rate of return standards to review Transmittal 2051. Furthermore, our review of applicable price cap rules indicates that, except for the $6.87 million technical correction described in that Order, Southwestern did not qualify under those rules for the requested changes in its July 1990 rates and related price cap indexes. Moreover, given the text of the *LEC Price Cap Order* and the timing of the Transmittal 2051 filing, we find Southwestern had adequate notice that this filing would be evaluated under price cap regulation. In view of the relief requested by Southwestern (*i.e.*, a change in Southwestern's July 1990 rates and related indexes) and Southwestern's failure to meet the substantive requirements of applicable Commission rules for such relief, the Bureau properly rejected Transmittal 2051 as patently unlawful under those rules.

B. Alternate Analysis Under Rate of Return Regulation

12. Since our decision to reject Transmittal 2051 is grounded in Southwestern's noncompliance with applicable price cap rules, the portions of the *Southwestern Mid-course Order* that respond to Southwestern's rate of return arguments represent an alternate ground to support our decision. We reaffirm our earlier conclusion that the Bureau properly applied price cap rather than rate of

return regulation to Transmittal 2051 and clarify that the discussion of Southwestern's rate of return argument was included only to address Southwestern's repeated claim that had rate of return regulation been applied to Transmital 2051, we would have been compelled to allow Southwestern to make all requested rate increases.

13. The *Southwestern Mid-course Order* identified several specific concerns the Commission had relating to LEC mid-course corrections made during the period between adoption of our price cap rules and the first price cap tariffs becoming effective. This Commission wanted to discourage such corrections from being used to secure unjustified rate increases during that period.[16] Accordingly, this Commission took several significant steps to limit opportunities for such unjustified aggregate rate increases. For example, the initial January 1, 1991, price cap indexes were calculated starting from LEC access rates in effect on July 1, 1990—a date prior to the adoption and release of the *LEC Price Cap Order*. In addition, this Commission required that each LEC's aggregate rates effective on January 1, 1991, be equal to or below its aggregate July 1, 1990 rates, adjusted for the change in the authorized rate of return which became effective on January 1, 1991. By capping each LEC's January 1, 1991, rates on the basis of its July 1990 rates, this Commission was able to assure that between July 1 and December 31, 1990, any rate increase for a particular service was offset by a rate decrease for a different service.

14. While attempting to guard against improperly increased rates prior to the start of price caps, this Commission had a competing concern that a carrier might, in a truly extraordinary situation, find its maximum permissible rates were confiscatory or that these rates would otherwise cause that carrier to only reach a level of earnings significantly below the authorized return for rate of return car-

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[16] *See Southwestern Mid-course Order*, 7 FCC Rcd at 2908 (paras. 16-17) *citing LEC Price Cap Order*, 5 FCC Rcd at 6814, 6816-17 (paras. 230-231, 245-250).

riers.[17] Accordingly, if the July 1, 1990, rates subsequently proved to be unrealistically low, the *LEC Price Cap Order* left open the possibility that LECs could file mid-course corrections that would increase their July 1990 rates not only during the period prior to price cap tariffs becoming effective but also thereafter.

15. The *Supplemental Notice* was released by the Commission in March 1990[18] because the Commission recognized that it might receive mid-course corrections from LECs, like Southwestern, that claimed to be underearning in their final year of rate of return regulation. In its *Supplemental Notice,* the Commission proposed that such mid-course corrections be allowed to increase (or reduce) these LECs' July 1990 rates if such corrections became effective prior to the proposed price cap filing date and if these filings simply remedied under- (or over-) earnings situations encountered by these LECs. If a given LEC's mid-course correction met these requirements, the Commission proposed to treat the change in that LEC's July 1990 rates through a routine exogenous adjustment to that LEC's Price Cap Index.[19]

16. However, this Commission did not adopt that proposal, instead declaring in Footnote 315 to the *LEC Price Cap Order* that since it had just conducted a full review of access filings for rates effective July 1, 1991, any mid-course corrections during the six month period leading up to price cap regulation would likely be premature. The Commission stated that it would "not give any such corrections routine exogenous treatment."[20] This footnote made it much more difficult for LECs to justify mid-course

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[17] *See LEC Price Cap Order,* 5 FCC Rcd at 6801-6802 (paras. 121, 127-128).

[18] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 87-313, Supplemental Notice of Proposed Rulemaking, 5 FCC Rcd 2176 (1990) (*Supplemental Notice*).

[19] *See Supplemental Notice,* 5 FCC Rcd at 2281 (para. 228-229).

[20] *LEC Price Cap Order,* 5 FCC Rcd 6848 n.315.

corrections to their July 1990 rates and indicated that any such corrections would be carefully scrutinized. As we noted in the *Southwestern Mid-course Order*, this footnote did not guarantee that rates would in fact earn exactly the authorized rate of return on the eve of price cap regulation, but rather established a general mechanism to ensure that carriers would not be unfairly handicapped as they enter price cap regulation.[21] Thus, we reaffirm our finding in the *Southwestern Mid-course Order* that, to the extent rate of return regulation applied, the *LEC Price Cap Order* requires review of LEC mid-course corrections under more stringent criteria than those traditionally prevailing under rate of return regulation,[22] and that the Southwestern filings would not have satisfied these criteria even if rate of return regulation had been applicable.

IV. CONCLUSION AND ORDERING CLAUSE

17. We have reexamined Southwestern's Application for Review, the associated oppositions, Southwestern's reply to those oppositions, as well as the related filings. As discussed above, we affirm, as clarified, the *Southwestern Mid-course Order*.

18. Accordingly, IT IS ORDERED, that the findings and conclusions set forth in this Commission's *Southwestern Mid-course Order* ARE HEREBY AFFIRMED, as clarified in this Order.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

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[21] *Southwestern Mid-course Order*, 7 FCC Rcd at 2908-09 (para. 19).

[22] We also clarify that the *Southwestern Mid-course Order* uses Southwestern's early retirement plan only as an example of the type of expense that must be examined in detail when such a higher standard is applicable. We did not then and do not now rely on the expenses of that plan to deny Southwestern any of the rate relief it seeks.

SEPARATE STATEMENT OF COMMISSIONER ANDREW C. BARRETT DISSENTING IN PART

Re: In the Matter of Southwestern Bell Telephone Company's Mid-Course Order on Remand

Following the Commission's request that the Court remand this matter for further consideration, I assumed that the Commission would fully consider the points raised in my dissent in this matter. My assumption was incorrect. The Commission still fails to address the valid issues I pointed out in my dissent. While the opinion addresses many issues, it cannot justify the new standards adopted for Southwestern Bell's (SWB's) mid-course correction. As I previously stated,

> it appears that the Commission for the first time articulate[d] a new more stringent standard for these type filings. The Order notes that the Commission "implicitly" suggested review of mid-course corrections under more stringent criteria than those traditionally prevailing under rate of return. However, nowhere do I find that SWB was given explicit notice that it would be held to a more stringent standard when it filed its mid-course correction or afterwards. Nor can I find any articulation of the heightened standard to be applied. Instead, SWB received a waiver of Section 61.38(b)(1). Letter to SWB, from J. Cimko, Chief, Tariff Division, Common Carrier Bureau, FCC, dated Nov. 29, 1990. This waiver of the cost support data was granted subsequent to the Commission's release of the *LEC Price Cap Order*. Although the waiver did not, as the Commission's Order notes, constitute approval of the proposed filing, it may have provided SWB with an understanding that its mid-course correction would not

be subjected to the heightened review standard the Commission now articulates in this Order.[1]

As I pointed out previously, my main concern was and still is with the Commission adopting a new more stringent standard without providing SWB with adequate notice. The Commission never made SWB fully aware of the new standards until after its mid-course correction was rejected. Indeed, it was provided an [sic] waiver of the cost support data before the new standards were implemented. I believe it important that the Commission speaks in a clear and consistent manner. It has not done so in this case. Accordingly, I must continue to dissent. Perhaps, the Court can convince the Commission to address this issue.

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[1] Statement of Commissioner Andrew C. Barrett Dissenting In Part, 7 FCC Rcd 2906, 2920 (1992) (footnotes omitted).

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 92-1220

SOUTHWESTERN BELL TELEPHONE COMPANY,
Petitioner

v.

FEDERAL COMMUNICATIONS COMMISSION and
UNITED STATES OF AMERICA,
Respondents

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, *et al.*,
Intervenors

BEFORE: Mikva, Chief Judge; Wald and Edwards, Circuit Judges

ORDER

[Filed Oct. 30, 1992]

Upon consideration of the motion for remand, the response thereto, the reply, the motion for leave to file a further response, and the further response, it is

ORDERED that the motion for leave to file a further response be granted. The Clerk is directed to file the lodged document. It is

FURTHER ORDERED that the motion to remand the case be granted. The court notes the Federal Communications Commission's assurance that "a staff-prepared draft order will be completed and forwarded to the Com-

missioners along with a staff recommendation by the end of the calendar year."

The Clerk is directed to withhold issuance of the mandate herein until seven days after disposition of any timely petition for rehearing. *See* D.C. Cir. Rule 15.

Per Curiam

/s/ [Illegible]

/s/ [Illegible]

/s/ [Illegible]

APPENDIX D

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

Transmittal No. 2051

IN THE MATTER OF

SOUTHWESTERN BELL TELEPHONE COMPANY
APPLICATION FOR REVIEW

MEMORANDUM OPINION AND ORDER

Adopted: April 10, 1992; Released: May 6, 1992

By the Commission: Commissioner Barrett dissenting in part and issuing a statement.

I. INTRODUCTION

1. On May 3, 1991, Southwestern Bell Telephone Company (SWB) filed the above Application for Review (SWB Application) of a Common Carrier Bureau (Bureau) Order released April 9, 1991.[1] The Bureau Order rejected SWB's earlier Transmittal 2051 through which SWB had sought to increase its access tariff rates for the remainder of the 1990-1991 access period, thereby adjusting the base rates that would be used for price cap purposes in the first six months of 1991 and subsequent periods. On March 22, 1991, just prior to the release of

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[1] Southwestern Bell Telephone Company, Revisions to Tariff F.C.C. No. 68, Transmittal No. 2051, 6 FCC Rcd 2089 (Com.Car. Bur. 1991) (*Bureau Order*).

the Bureau Order, SWB filed an Application for Special Permission to file tariff revisions that would increase its access tariff rates above those in Transmittal 2051.[2] On May 15, 1991, the Bureau issued a letter which declared Application 257 moot and dismissed the waiver request which accompanied Application 257.[3]

2. Oppositions to the SWB Application were filed on May 20, 1991, by American Telephone and Telegraph Company (AT&T Opposition) and by MCI Telecommunications Corporation (MCI Opposition). SWB filed a reply to these oppositions on June 4, 1991 (SWB Reply). In addition, on June 14, 1991, SWB filed an Application for Review and Request for Consolidation (SWB Request), in which it asked this Commission to "remand" the Bureau Letter and to consolidate our review of the dismissal of Application 257 with our consideration of the subsequent SWB Application for Review.

3. Based upon our review of the SWB Application, the SWB Request, and related filings in this matter, we affirm the Bureau's rejection of SWB's request to increase its rates, except that we will allow one $6.87 million correction to SWB's July 1, 1990, access rates and related price cap indexes.

II. BACKGROUND

4. Along with other local exchange carriers (LECs), SWB filed its annual access tariff revisions in April 1990 to establish rates that would become effective July 1, 1990. In that filing, SWB sought to decrease its access rates by approximately $99 million. In an order released June 21,

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[2] Application for Special Permission No. 257, filed by Southwestern Bell Telephone Company, March 22, 1991 (*Application 257*).

[3] Letter to Southwestern Bell Telephone Company from J. Cimko, Chief, Tariff Division, Common Carrier Bureau, FCC, dated May 15, 1991 (*Bureau Letter*).

1990, the Bureau disallowed approximately $53 million of those rates.[4] Thus, SWB's original transmittal, as modified by the 1990 Access Order, resulted in a total reduction of approximately $152 million in the SWB access rates that became effective on July 1, 1990.[5]

5. On October 4, 1990, this Commission released the *LEC Price Cap Order* which made SWB and certain other large LECs subject to mandatory price cap regulation effective January 1, 1991.[6] We required such LECs to use their July 1, 1990, access rates as the starting point for price cap regulation.[7] We also required price cap LECs to set both their Price Cap Indexes (PCIs) and their Actual Price Indexes (APIs) at a level of 100, as of July 1,

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[4] The $53 million in total disallowances included approximately $47 million in disallowed expenses and a disallowance of approximately $6 million relating to a recalculation of SWB's Carrier Common Line demand. *See* Annual 1990 Access Tariff Filing, CC Docket No. 90-320. Memorandum Opinion and Order, 5 FCC Rcd 4177 (Com.Car.Bur. 1990) (*1990 Annual Access Order*); Annual 1990 Access Tariff Filings, CC Docket No. 90-320, Order, 5 FCC Rcd 4142 at 4173 (Com.Car.Bur. 1990) (*1990 Annual Access Order Revisions*), *applications for review pending:* Annual 1990 Access Tariff Filings, CC Docket 90-320, Memorandum Opinion and Order, 5 FCC Rcd 6015 (Com.Car.Bur. 1990) (*1990 Annual Access Order Erratum*).

[5] Later in 1990, the Bureau made a further modification that reduced the disallowance by approximately $625,000 on the basis of a revised demand analysis. *See 1990 Annual Access Order Erratum*, 5 FCC Rcd at 6045(b).

[6] Second Report and Order, 5 FCC Rcd 6786, 6818 (para. 262) (1990) and Erratum, 5 FCC Rcd 7664 (1990) (*LEC Price Cap Order*), *modified on recon.*, 6 FCC Rcd 2637 (1991), *petitions for recon. of ONA Part 69 Order pending, petitions for further recon. dismissed*, 6 FCC Rcd 7482 (1991), *further modified on recon.*, 6 FCC Rcd 4524 (1991) (*ONA Part 69 Order*), *petitions for recon. of ONA Part 69 Order pending, appeal docketed, D.C. PSC v. FCC*, No. 91-1279 (D.C. Cir. June 14, 1991).

[7] *See LEC Price Cap Order*, 5 FCC Rcd at 6814 (para. 230). *See also* Section 61.48(d) of this Commission's Rules, 47 C.F.R. § 61.48(d).

1990. Our use of historical rates reflected our belief that such a requirement would prevent price cap LECs from engaging in any aggregate price increases in the interim period between the release of our Order and the initiation of our price cap system on January 1, 1991.[8] We adopted the July 1, 1990, rates as a starting point to prevent any manipulation of the base rates.

6. On December 4, 1990, SWB filed Transmittal No. 2051 to increase its July 1, 1990, rates by $37.6 million. SWB described Transmittal 2051 as a midcourse correction to its July 1, 1990, rates. The Bureau rejected Transmittal 2051 on April 9, 1991, finding that such adjustments to July 1, 1991, rates and the related indexes are not allowed under our price cap regulations or the *LEC Price Cap Order*. Though the Bureau Order rejected the transmittal on grounds that SWB had not conformed to the price cap rules for such filings, the Bureau also said, "it appears doubtful that this midcourse would have been accepted in the absence of additional cost justification even if the price cap rules had not been adopted." [9]

7. In Application 257, pending at the time the Bureau Order was released, SWB sought to file further revisions to its July 1, 1990, access rates that would have enabled SWB to increase those rates by an additional $28.3 million. Since Application 257 presumed the effectiveness of Transmittal 2051 and was described by SWB as an "extension" of the transmittal,[10] the Bureau on May 15, 1991, declared Application 257 moot in light of its rejection of Transmittal 2051.[11]

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[8] *See LEC Price Cap Order*, 5 FCC Rcd at 6814 (para. 231).

[9] *Bureau Order*, 6 FCC Rcd at 2091. In view of our decision on the SWB Application, we need not address the Bureau's observation on the likely disposition of Transmittal No. 2051 under rate of return regulation.

[10] *Application 257* at 2. *See also* SWB Reply to Oppositions at 3.

[11] *Bureau Letter* at 1.

III. APPLICABLE STANDARD

A. Pleadings

8. SWB contends that the Bureau improperly employed price cap regulation to reject Transmittal 2051 and that rate of return analysis would not support rejection of this transmittal. SWB asserts that our *LEC Price Cap Order* authorized price cap LECs such as SWB to file "new effective prices" justified under existing rate of return requirements in the period leading up to price cap regulation.[12]

9. SWB also challenges the Bureau's finding that if Transmittal 2051 had been subject to rate of return regulation, it would still have been rejected for failure to comply with Section 61.38 cost support requirements. SWB contends that this latter finding was based on four errors by the Bureau. SWB first contends that it obtained a waiver of Section 61.38 requirements and that, once the waiver was granted, the Bureau could no longer object that SWB had failed to comply with the terms of that section.[13]

10. Next, SWB contends that the Bureau Order improperly restricted SWB's ability to revise its rates. SWB claims that the Bureau Order conflicts with past Commission practice and regulations that allowed mid-course adjustments to be filed if reasonably incurred actual costs and the associated revenues conflicted with the projected data on which the original rates were based.[14] SWB also contends that it could file no sooner than it did since the

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[12] SWB Application at 6-7 (*citing LEC Price Cap Order*, 5 FCC Rcd at 6816 and claiming Transmittal 2051 fits precisely within this window).

[13] *Id.* at 19-20 (adding that the cost support provided with Transmittal 2051 was more detailed than that required by the waiver and was better than the support provided with SWB's earlier annual access filing).

[14] *Id.* at 2-3 (claiming that it elected not to appeal certain 1990 disallowances in reliance on such past practice).

cost support necessary to substantiate its mid-course filing was not yet available, but, that when it was finally able to file, SWB was unfairly required to meet price cap requirements.[15] SWB argues that the Bureau Order therefore has the effect of unfairly implementing price cap regulation on an *ex post facto* basis, retroactive to July 1, 1990.[16]

11. Third, SWB claims that the Bureau Order incorrectly characterizes the separations impact of SWB's Transmittal No. 2051.[17] In particular, SWB challenges the Bureau's conclusion that revised separations studies were the "substantial" reason for the filing of SWB's Transmittal No. 2051.[18]

12. Fourth, SWB challenges the Bureau's reliance on the forecast costs associated with SWB's July 1, 1990, rates.[19] SWB employs trend analysis in its Application for Review to show that its projected expenditures and revenue requirements are consistent with its historical cost trends. While some of this data was not available when SWB submitted Transmittal 2051, SWB contends that when such comparisons are made, the costs projected in Transmittal 2051 compare reasonably with actual costs for prior tariff periods.[20] For example, in the SWB Application, SWB performs a trend analysis to support the reasonableness of the revenue requirements set forth in Transmittal 2051.[21] In another analysis, SWB computes a trend regression using quarterly ARMIS data and demonstrates that the expenses actually projected for July 1990-June 1991 in Transmittal 2051 are less than the regression

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[15] *Id.* at 21.

[16] *Id.* at 9.

[17] *Id.* at 17.

[18] *Id.* at 18 (*citing Bureau Order*, 6 FCC Rcd at 2091).

[19] *Id.* at 11.

[20] *Id.* at 13, 19.

[21] *Id.* at 14-15.

forecast for those same expenses.[22] On the basis of such analysis, SWB contends that the level of taxes and other expenses included in Transmittal 2051 is lower than the actual amounts for 1990 and these costs are also lower than the amounts predicted by SWB's regression model based on historical data.[23]

13. In their oppositions to the SWB Application, AT&T and MCI concur with the Bureau that Transmittal 2051 was subject to price cap rather than rate of return regulation.[24] AT&T also argues that the clear intent of the Commission's reference to "new effective prices" is that any revised rates under rate of return regulation between July 1 and December 31, 1990, were required to become effective during that period.[25]

14. On the adequacy of SWB's cost support, AT&T notes that SWB's forecasted earnings underrun was based on only three months of actual cost data and four months of revenue data and points out that the Commission has previously found in similar circumstances that such a "scanty" data submission diminishes the statistical validity of forecasts based on such data.[26] In addition, MCI chal-

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[22] *Id.* at 13-15 (noting that its fourth quarter 1990 expenses were reduced to eliminate the impact of certain "one-time" extraordinary expenses).

[23] *Id.* at 15. *But see* AT&T Opposition at 6-7. *See also* SWB Reply at 3-4.

[24] AT&T Opposition at 3-5; MCI Opposition at 1-2.

[25] AT&T Opposition at 4 n** (further contending this interpretation is confirmed by the Commission's explicit refusal in its *LEC Price Cap Order*, 5 FCC Rcd at 6848 n.315, to make "routine" adjustments to price cap levels even for mid-course corrections which became effective in the six months before January 1, 1991).

[26] *Id.* at 7 (*citing 1990 Annual Access Order*, 5 FCC Rcd at 4200; *also*, Section 61.38(b)(1)(i) of our Rules, 47 C.F.R. Section 61.38(b)(1)(i), which normally requires rate of return tariff changes to be supported by 12 months of cost data). While Trans-

lenges SWB's cost support claiming certain corrections are needed and that, when those corrections are made, MCI finds that SWB's initial [p]rice cap rates will provide SWB with a reasonable opportunity to earn its authorized rate of return.[27]

15. SWB disputes the contentions of AT&T and MCI that the Bureau correctly evaluated Transmittal 2051 under price cap regulation. SWB says AT&T ignores the fact that SWB requested a waiver of the Section 61.58 notice requirements to allow these changes to take effect prior to January 1, 1991, and that only the Bureau's denial of that waiver request forced the proposed effective date to be in 1991.[28] Furthermore, SWB specifically disputes MCI's claim that SWB filed erroneous cost and revenue data and explains how it handled each of the items highlighted by MCI.[29]

B. Discussion

1. Effect of *LEC Price Cap Order*

16. SWB's insistence that its Transmittal 2051 must be treated as an ordinary rate of return mid-course correction to its July 1, 1990 annual filing is premised on a reading of the *LEC Price Cap Order* that departs from the Order's intent. The *LEC Price Cap Order* discussed how to prevent unjustified aggregate rate increases in the months leading up to the changeover to price cap regulation on January 1, 1991.[30] Unjustified aggregate in-

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mittal 2051 provided only the limited cost and revenue data noted by AT&T, in Application 257 SWB did provide additional data to support its contentions. *See*, para. 21, *infra*.

[27] MCI Opposition at 5-7.

[28] SWB Reply to Oppositions 4 n.7.

[29] *Id.* at 3.

[30] *LEC Price Cap Order*, 5 FCC Rcd 6814, 6816-17 (paras. 230-231, 245-250) and Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873,

creases in rates would have several adverse consequences: (1) higher base rates give a carrier enhanced pricing flexibility in a price cap system; (2) while price caps will drive rates down over time, there is no immediate opportunity to retarget rates as there is in a rate of return system in which rates are retargetted annually; and (3) an unjustified set of rates that are "too high" in an economic sense gives a carrier an added ability to achieve a productivity target without actually achieving true productivity gains. Carriers therefore have obvious and strong incentives to initiate price cap regulation with rates that are inflated by rate of return standards.

17. Concerned about rate inflation on the eve of price cap regulation, the Commission took steps primarily designed to guard against such inflation. First, although price cap regulation was not initiated until January 1, 1991, price cap indexes were calculated as of July 1, 1990. Thus, the rates in effect on July 1, 1990 were considered to be at the price maximum, or price cap. Second, rates on January 1, 1991, were required to be at or below the price cap maximum as of that date. Calculating the indexes in advance of price cap implementation, and requiring rates to be at or below the cap as of January 1, 1991, required any increase in one rate occurring after July 1, 1990, to be offset by a decrease in a different rate.

18. As an initial matter, use of July 1, 1990, rates was intended to ensure that price cap LECs had a reasonable opportunity to earn the authorized rate of return in the months leading up to price cap regulation. Rates in effect July 1, 1990, were the product of an annual retargetting of prices to the authorized rate of return that in-

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3249-50 (paras. 778-780) (1989) (*Second Further Notice*), *citing* Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3436-39 (paras. 447-453) (1988). *See also Second Further Notice* 4 FCC Rcd at 3089-92 (paras. 431-438) (discussing identical issue with respect to price cap regulation of AT&T).

cludes an evaluation of LEC rates and costs. During the annual access tariff review process, the reasonableness of such increases are typically evaluated in light of the average actual cost changes experienced by LECs as a group as well as the actual cost changes historically experienced by the individual LEC.[31] After SWB and other LECs filed their 1990 annual access tariff filings, the Bureau undertook such an analysis. Out of that process evolved the July 1, 1990, rates for the July 1990-June 1991 access year.

19. In addition to guarding against improperly increased rates prior to the start of price caps, this Commission had a competing policy concern that a carrier might for unforeseen reasons, or other reasons beyond its control, find itself with rates that produced earnings significantly below the authorized return.[32] Accordingly, if the July 1, 1990, rates subsequently proved to be unrealistically low, the *LEC Price Cap Order* left open the possibility that a LEC could file an aggregate rate increase. The Commission indicated that any such rate increase would generally not change the starting point for price cap regulation, but did leave open the possibility that this could occur in non-routine cases. This was not a guarantee that rates would in fact be earning exactly the authorized return on the eve of price caps, but simply a recognition of a general concern that carriers should not be unfairly handicapped as they enter price cap regulation. Specifically, the Order acknowledged that mid-course corrections to July 1, 1990, rates could be filed.[33] Acceptance of such a filing would result in an upward adjustment to the price cap so that rates, instead of being

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[31] *See, e.g.*, Annual 1989 Access Tariff Filings, Memorandum Opinion and Order, 4 FCC Rcd 3638, 3639 and Appendix B (Com. Car.Bur. 1989).

[32] *See LEC Price Cap Order*, 5 FCC Rcd at 6801-6802 (paras. 121, 127, 128).

[33] *Id.*, 5 FCC Rcd at 6816 (para. 245).

above the cap, would be at the cap.[34] Although the mechanics of such an adjustment were specified, there was no suggestion in the Order that aggregate rate increases would be permitted as a matter of course. Indeed, paragraph 245 of the *LEC Price Cap Order* suggests the opposite. Furthermore, the Order stated that "routine" increases in the price cap would not be granted for carriers seeking upward adjustments to July 1, 1990, rates as a result of under-earnings during the six months leading to the changeover to price cap regulation.[35] Stated differently, the policy concerns that led to a stated reluctance to allow aggregate rate increases immediately prior to the changeover implicitly suggests review of mid-course corrections under more stringent criteria than those traditionally prevailing under rate of return. In addressing the details of such scrutiny in this case of first impression, we believe that to justify such a mid-course correction: (1) a carrier must provide a detailed explanation of expenses that are not being recovered by July 1, 1990, rates; and (2) the Commission should examine those expenses with reference to the change in regulatory regimes. Only by examining a mid-course correction under such heightened scrutiny would this Commission be able to decide if a LEC's rate increases were an improper attempt to inflate its July 1990 rates in advance of caps, or a justified rate increase.

20. An example of the type of expense that illustrates the problems we faced in policing rates on the eve of price cap regulation is SWB's decision to institute an early retirement program in the fourth quarter of 1990.[36]

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[34] *See* Part 61.45(g) of the Commission's Rules, 47 C.F.R. § 61.45(g).

[35] *See LEC Price Cap Order*, 5 FCC Rcd 6848 n. 315 (declaring mid-course corrections during the six-month period prior to the changeover to price cap regulation would not be given routine exogenous treatment).

[36] *See* SWB Application at 16. Under SWB's Management Force Adjustment Program, SWB offered incentives to certain company

This expense was noted for the first time in SWB's Application for Review. On its surface, having ratepayers pay for an early retirement program would not appear to violate rate of return principles since the higher expenses and higher rates paid today should result in lower expenses and lower rates in the future. But price caps operates very differently from rate of return. Under price cap regulation, the decision to implement such a program would not result in an increase in the price cap; since prices do not change, shareholders (not ratepayers) bear the burden of the decision to increase expenses. In the future, shareholders would eventually reap the benefit of such a decision, so long as the program leads to lower future expenses. During the transition from rate of return regulation to price caps, however, allowing rates to rise on the eve of price caps would mean that ratepayers pay higher rates while LEC shareholders retain all potential future benefits.[37]

2. Evaluation of Cost Support

21. An examination of SWB's cost support with reference to this heightened level of scrutiny reveals that SWB has not made its case, with one exception. SWB's explanations of the alleged failure of SWB's July 1, 1990, rates to recover costs have been incomplete. The bulk of the increased expenses SWB presents are not specific, discrete expenses that have changed since July 1, 1990. SWB's cost support is based on overall expenses that SWB estimates will occur based on a limited period of actual operating results. In its original Transmittal 2051, SWB supported its higher rates based on only three months of actual cost data, and four months of actual

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managers who voluntarily chose to retire or leave SWB before December 31, 1990.

[37] This is not to suggest that SWB did anything untoward in instituting an early retirement program. The example is used to illustrate how the analysis of an expense must account for the transition from one regulatory regime to another.

revenue data, which SWB argued should be the basis for increasing price cap base rates.[38] SWB also supported its Transmittal 2051 with "subject to separations" data from one month's actuals. Since SWB has not based its Transmittal 2051 cost support on post July 1, 1990, cost changes, SWB's argument is that the expenses the Bureau allowed for the access year beginning July 1, 1990, are generally insufficient in light of subsequent actual expenditures by SWB. Stated differently, SWB argues the July 1, 1990 starting point for price cap base rates is wrong.

22. To evaluate that claim, we have examined the mid-course from two vantage points: first, with respect to SWB's actual expenses reported through the ARMIS process; and, second, with respect to the analysis undertaken by the Bureau in making partial disallowances to SWB's July 1, 1990 rates. This examination has answered some questions about the calculation of SWB's July 1, 1990, rates but has also raised other questions about the expenses SWB actually incurred in the course of the 1990-1991 tariff year. For example, the ARMIS data filed by SWB showed a large increase in expenses in the fourth quarter of 1990. This increase was well above the normal fourth quarter increase expected given SWB's

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[38] These actuals were later supplemented in Application 257 to include six months of cost data and eight months of revenue data. In addition, we note that the Bureau Order contains *dicta* to the effect that SWB supported Transmittal 2051 in part through the incorporation of changes included in SWB's revised separations studies which changes would produce an increased allocation of costs to SWB's interstate services. *See Bureau Order*, 6 FCC Rcd at 2091. Based on information filed in the SWB Application, it now appears that, if these study changes were permitted, SWB's interstate access costs would not increase but would, in fact, be reduced. While we concur with SWB that its revised separations studies would not have increased SWB's allocation of costs to its interstate service, this clarification would not appear to qualify these studies for consideration in making a mid-course adjustment for SWB. *See* note 51, *infra*.

quarter-to-quarter variation in expenses. That large and unexplained increase led SWB to report a 7.63 percent rate of return for that quarter.[39] No explanation has been offered for this sudden increase in expenditures,[40] other than the expenses of an early retirement plan, discussed *supra*, and the centralization of computer operations. However, these expenses account for only a portion of the increased expenses that SWB reported.[41]

23. Moreover, the evidence SWB submitted in its Application for Review does not further our understanding of the issue. First, SWB relies on trends derived from nine quarters of data on its total operating expenses (subject to separations) reported in ARMIS for January 1988-March 1990. As this data necessarily includes the four quarters of ARMIS data from calendar year 1988, it is unreliable due to certain problems encountered with

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[39] *See* SWB ARMIS Report 43-01 (Quarterly Report), 4Q1990.

[40] These cost increases experienced by SWB were not evident for the other RBOCs, and had not been experienced by SWB in previous years. *See* Appendixes A, B-1 and B-2.

[41] Analysis of SWB's ARMIS reports for the third and fourth quarters of 1990 shows an increase in the fourth quarter over the third quarter of $171 million in SWB's total operating expenses (subject to separations). SWB ARMIS Report 43-01 (Quarterly Report), 3Q1990 and 4Q1990. Of this amount, $70 million appears to be attributable to SWB's implementation of its Management Force Adjustment Plan and to centralization of its computer operations. *See* SWB Application at 14. The trend model used by the Bureau in the course of reviewing SWB's 1990 annual access tariff filing predicted only a one percent increase in expenses less depreciation (subject to separations) in the fourth quarter of 1990. Although that category of expenses differs somewhat from the category of expenses reported by SWB in ARMIS, the differences should not cause the growth rates of the two categories to differ greatly. Applying the one percent growth rate to SWB's third quarter ARMIS data results in a predicted increase of only $13 million for the fourth quarter of 1990. Thus, approximately $88 million of the $171 million increase remains unexplained ($171 million − $70 million − $13 million = $88 million).

SWB's quarterly ARMIS data for 1988.[42] Accordingly, except as noted below, the forecast costs that ultimately formed the basis for SWB's July 1, 1990, access rates remain the best available measure of the reasonableness of the actual costs later incurred by SWB in the course of the tariff year.

24. In a letter submitted November 1, 1991, SWB renews the argument made in its Application for Review that its expenses projected in Transmittal 2051 for the period July 1990 through June 1991 are nearly identical to actual expense growth experienced in recent tariff years, and that therefore the rates filed in Transmittal 2051 to recover those expenses are fully justified.[43]

25. SWB's analysis, based on data from 1988 through the first quarter of 1991, yields a different growth rate than the Bureau analysis employed in the *1990 Access Tariff Order* which analysis includes data from 1986 through 1989.[44] SWB contends that use of the pre-1988 data is not reasonable because the change to Part 32

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[42] When SWB and many other LECs originally filed their quarterly 1988 ARMIS data, the Bureau found an unusual number of errors. The Bureau directed them to simply refile this data on an annual rather than a quarterly basis, which they did. Earlier this year, SWB elected to refile its quarterly ARMIS data for 1988. *See* SWB ARMIS Report 43-01 (Quarterly Report), 1Q1988-4Q1988 (revised), filed Feb. 27, 1991. However, the revised SWB 1988 quarterly ARMIS data was not entirely consistent with the SWB 1988 annual ARMIS data filed earlier. We cannot under the circumstances place reliance on the SWB quarterly ARMIS data for 1988.

[43] Letter to Chief, Common Carrier Bureau, FCC, from D. Hubbard, Vice President, SWB, dated November 1, 1991 (*November 1 Letter*).

[44] The two analyses also differ in the type of expense they examine. SWB looks at operating expenses and other taxes, while the Bureau's analysis employed expense less depreciation. However, these different data sources do not appear to account for the differences in the two growth rates.

accounting rules, effective January 1, 1988, makes it inappropriate to compare the periods before and after this date. SWB also notes that it incurred unusual expenses in 1986 that made SWB's total expenses in that year unusually high.[45] In light of this, we believe the best course is to revise the trend analysis in the *1990 Annual Access Order* to exclude the anomalous 1986 data points. As noted in Appendix C, we base this belief upon our determination that the 1986 data points were unduly influenced by several significant one-time annual expenses incurred by SWB in 1986. However, we retain the 1987 data because the accounting change was already reflected in the original analysis.

26. Under the Bureau's original analysis, SWB's projected 2.8 percent growth rate was replaced with the Tier 1 LEC average 1.3 percent growth rate which process yielded a disallowance of $16.02 million. Had the analysis used data from 1987 through 1989, the disallowance would have been only $9.15 million.[46] Since it has been our practice to exclude data points that carriers have adequately explained are anomalous, we find that SWB's price cap base rates should be adjusted upward by $6.87 million.[47]

27. An adjustment to the disallowances made in the Bureau's *1990 Annual Access Tariff Order* is consistent with the Bureau's treatment of other LECs in that Order.[48] The adjustment also is responsive to SWB's un-

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[45] *See* Letter to Chief, Tariff Division, Common Carrier Bureau, FCC, from W. Blase, Director—Federal Regulatory, SWB, dated Nov. 15, 1991.

[46] For a detailed explanation of the analysis, see Appendix C.

[47] Of the $6.87 million amount involved here, we calculate $4.8 million should be allocated to common line, $1.466 million to traffic sensitive switched, and $0.604 to special access. *See also* Appendix C.

[48] *See 1990 Annual Access Tariff Order*, 5 FCC Rcd at 4269, Appendix C, Chart TPISDIS, p. 1 n.4 (declining to make final

derlying argument in Transmittal 2051 that price cap base rates were set too low.

28. The most straightforward way of partially reversing the disallowance is to have SWB recalibrate its indexes from July 1, 1990, as if higher rates were in effect. Recalibration of SWB's access rates as it enters price cap regulation is not the result of any higher-than-forecast SWB expenses [49] or any lower-than-expected SWB earnings. As noted elsewhere in this Order, SWB has not made the showings to merit such adjustments. Rather, because these July 1990 access rates will serve as an important benchmark for at least the remaining three years of price cap regulation of SWB, they should be based on the most accurate historical trend information that was available at the time the July 1990 access rates became effective.

3. Application of Price Cap Rules

29. Our review of the the [sic] issues thus far has discussed SWB's failure to meet the requirements of a mid-course rate increase requested while rate of return regulation still applied to SWB but sought just prior to the changeover to price cap regulation. SWB's mid-course correction, filed while it was still subject to rate of return regulation, actually straddled the changeover to price cap regulation

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certain tentative disallowances for six LECs because such disallowances would ignore significant changes in each of these LEC's TPIS trend data beginning with the first quarter 1986). *See also 1990 Annual Access Tariff Order*, 5 FCC Rcd at 4200 (para. 207) (declining to make final disallowances for Cincinnati Bell Telephone Company (CBT) because CBT's cost trend showed an anomalous shift after the third quarter of 1987; also declining to make final certain disallowances for Diamond State and New Jersey Telephone Companies in part because their cost trends appeared to show significant changes over time).

[49] We note that, in any event, the *November 1 Letter* did not attempt to justify the higher costs SWB sought to claim in Application 257.

on January 1, 1991. If there was any doubt on SWB's part as to the heavier burden it bore with respect to such a mid-course correction, that doubt should have been resolved by the undisputed fact that its mid-course was filed after price cap regulations became effective and that SWB's tariff revisions were not scheduled to become effective until after the changeover to price cap regulation.[50] Forty-five days is the normal notice period associated with LEC access filings. SWB's argument, that it sought but was denied special permission to file on shorter notice, is irrelevant. SWB chose when to file and knew when it filed that a new regulatory system was already in place.[51] We now examine SWB's mid-course filing for conformance with price cap requirements.

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[50] Our LEC price cap rules became effective October 31, 1990. *See* 55 FR 42375. SWB filed Transmittal 2051 December 4, 1990, with tariff revisions scheduled to become effective January 18, 1991.

[51] Of course, even if special permission had been granted to make the tariff effective before January 1, 1991, the heightened scrutiny the transmittal would have received due to the concerns expressed in the *LEC Price Cap Order* would have supported rejection of the transmittal since SWB offered an incomplete explanation of its costs. We also reject SWB's claim that the Bureau's waiver of Section 61.38(b)(1) foreclosed any Bureau inquiry into the cost support submitted in support of Transmittal No. 2051. SWB Application at 19-20. While the Bureau's waiver relieved SWB from the specific obligation of providing certain historical and forecast data under Section 61.38(b)(1), it did not relieve SWB of the general obligations in the portion of Section 61.38(b) before subsection (b)(1) to provide an explanation of the basis of rate-making employed. The Bureau's traditional practice has been that a midcourse correction cannot be justified by using a rate-making (*i.e.*, separations) methodology different than the one used in the annual access filing. *See Bureau Order*, 6 FCC Rcd at 2091. Thus, while we do not rule on this issue, it appears that SWB's separations study may be inappropriate in the context of a mid-course correction. We also note that the Bureau's waiver stated that it did not constitute approval of the proposed filing and did not prejudice any subsequent action which the Commission or Bureau may take. Letter to SWB, from J. Cimko, Chief, Tariff Division, Common Carrier Bureau, FCC, dated Nov. 29, 1990.

30. Price cap regulation provides three vehicles that can be used by carriers experiencing low earnings. One, an above-cap filing, can be used by carriers who argue that they cannot achieve the productivity gains required by the price cap system, and that therefore rates must be recalibrated to reflect actual costs regardless of the level of the price cap.[52] SWB has not made such a contention in this proceeding. The second vehicle, the price cap earnings adjustment, does not apply in the pre-price cap period and could not be used to alleviate earnings shortfalls in the second half of 1990.[53] The third vehicle is an extraordinary exogenous cost adjustment to raise its price cap and thus, its rates. In this case, SWB has not made the showing required for an exogenous adjustment.

31. Exogenous costs are one of three variables that determine how the price cap moves over time. They exist for two principle reasons: there are some cost changes that are imposed on carriers over which they have no control, and the Commission has determined that failure to recognize these cost changes in the price cap mechanism would work unfairness on ratepayers or carriers. While these costs are typically described as being outside a carrier's control, not all such costs are given exogenous treatment. Only a limited list of such costs are permitted to be factored into changes in the price cap. By creating a limited list of exogenous costs, a decision that was heavily debated and thoroughly discussed in the development of price cap rules, price cap regulation creates higher risks for carriers to balance against the higher

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[52] *See LEC Price Cap Order*, 5 FCC Rcd at 6823-24 (paras. 300-304).

[53] This adjustment is based on earnings in a calendar year. SWB's earnings for 1991 would have resulted in an upward adjustment to the cap if they were below 10.25 percent and a downward adjustment if they were above 13.25 percent. SWB has now reported a 10.74% rate of return for that year. Accordingly, use of the sharing mechanism to address alleged earnings shortfalls in 1991 is not appropriate.

financial rewards available under the system. At the same time, the system creates incentives for carriers to manage costs within their control.[54]

32. The *LEC Price Cap Order* did leave open the possibility of adjusting the cap for an exogenous cost not included in the limited list, by acknowledging that carriers could make case-by-case showings for extraordinary exogenous costs.[55] In doing so, however, the Order states that the possibility of making a successful extraordinary exogenous cost showing must be grounded in a demonstration that, without the adjustment, rates under price cap regulation would be confiscatory.[56] SWB, although it has alleged tariff year costs above those it expected and earnings below the targetted rate of return, has not made a sufficient showing that these changes are resulting in confiscation, as is discussed in Section IV, *infra*.[57]

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[54] *See LEC Price Cap Order*, 5 FCC Rcd at 6789-91 (paras. 21-37).

[55] *Id.*, 5 FCC Rcd at 6810 (para. 190) (acknowledging that in a "truly extraordinary situation," this Commission would approve above cap rates).

[56] *Id.*, 5 FCC Rcd at 6810 (para. 190).

[57] The decision to recalibrate SWB's price cap base rates by approximately $6.87 million is not an exogenous adjustment. However, it will have the same effect as an equivalent exogenous adjustment in that SWB will be able to raise its rates by about $6.87 million. In this regard our recalibration of SWB's base rates is no different from a recalibration of indexes that would occur, for example, if we resolve an outstanding Application for Review of the July 1, 1990, Bureau access decision in the carrier's favor. The *LEC Price Cap Order* contemplated that such adjustments could occur after implementation of the new system, and that since subsequent decisions could be reflected through a recalibration or exogenous adjustment, implementation of caps need not await resolution of these issues. *See, e.g., LEC Price Cap Order*, 5 FCC Rcd at 6817 (para. 250).

IV. CONFISCATION CLAIMS

A. Pleadings

33. By effectively denying the SWB request to adjust price cap indexes to reflect the Transmittal 2051 rates, SWB says the Bureau Order effectively denies SWB a reasonable opportunity to earn the authorized rate of return and severely impacts SWB's ability to improve the telecommunications infrastructure.[58] SWB also claims that Bureau Order results in an illegal confiscation of SWB revenue.[59] To support its confiscation claim, SWB notes that its Form 492 shows a 9.48 percent rate of return for the three quarters ending March 31, 1991, and that this figure is 135 basis points lower than its December 1990 estimate of 10.83 percent for this period in Transmittal 2051.[60] In an August 1991 letter to the Commission, SWB contrasted its interstate access rate of return results for the third and fourth quarters of 1990 (10.19% and 7.6 respectively) with its authorized rate of return for 1990 (12.0%) and similarly contrasted SWB's interstate access results for the first quarter of 1991 as a price cap carrier (10.64%) with the authorized rate in that year for rate of return carriers (11.25%).[61]

34. More specifically, SWB claims that contrary to the mandate of *AT&T v. FCC*, the decision to preclude an adjustment in the price cap index perpetuates an unlawful system in which this Commission can reduce SWB's rates and hence its rate of return, but SWB is barred from increasing its rates and thereby raising its pre-price cap

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[58] SWB Application at 8.

[59] *Id.* at 1 n. 2 (noting losses cannot be recouped).

[60] *See* SWB Reply at 5.

[61] Letter to Chairman, FCC, from E. Whitacre, Chairman and Chief Executive Officer, SWB, dated Aug. 21, 1991.

rate of return to the authorized level.[62] SWB asserts that the Bureau's Order, on the one hand, leaves SWB with no safeguard to protect its rate of return should its tariffed rates later be proven inaccurately low yet, on the other hand, reserves for the Commission the right to adjust those rates down if the rates are proven inaccurately high. Thus, in SWB's view, the Bureau's Order creates the kind of "systematic bias" previously rejected in *AT&T v. FCC.*

35. SWB further contends that the Bureau Order foreclosed SWB's use of the rate of return regulation rules in effect prior to January 1, 1991, and effectively locked-in SWB's July 1, 1990, rates with absolutely no opportunity for upward adjustment. On this basis, SWB claims the Bureau Order contradicts this Commission's policy recognizing the availability of mid-course corrections to assure LECs an opportunity to achieve their prescribed rate of return.[63]

36. In addition, SWB argues that the Bureau's failure to allow SWB an opportunity to earn the authorized rate of return going into price cap regulation is confiscatory. Citing the description of the confiscation test in *Illinois Bell*, SWB contends that the "net effect" or "end result" of a rejection of Transmittal 2051 would force SWB to earn less than the authorized rate of return and thus

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[62] *AT&T v. FCC*, 836 F.2d 1386 (D.C. Cir. 1988) (*AT&T v. FCC*). Here the court rejected a refund mechanism we adopted for the LECs under rate of return regulation because it found a "systematic bias" that compelled carriers to forfeit overearnings yet at the same time absorb deficiencies.

[63] SWB Application at 9 (*citing Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers*, CC Docket No. 84-800. Phase I, FCC 85-527, 50 FR 41350, 41355 (1985), *recon.*, FCC 86-114, 51 FR 11033 (1986), *further recon.*, 2 FCC Rcd 190 (1987), *rev'd in part, AT&T v. FCC*).

deprive its investors of an opportunity to earn a proper return on their investment.[64]

37. AT&T disputes SWB's claim that *AT&T v. FCC* compels this Commission to allow LECs to increase their rates simply because this Commission retained the right to reduce their rates.[65] Unlike the mechanism the Court of Appeals addressed in that case, AT&T notes that the Commission's price cap regulations provide relief for both over- and underearnings: overearnings are remedied through a sharing mechanism and underearnings are remedied by the operation of the 10.25 percent "low end adjustment."[66]

38. On the issue of possible confiscation, AT&T notes that the Commission found that a 10.25 percent rate of return is "still within the range of costs of capital for other public utilities" and that SWB fails to provide any basis for refuting this finding.[67] Accordingly, AT&T concludes that SWB fails to demonstrate any confiscation in this case and that SWB can seek a "low end adjustment" if such confiscation is threatened.[68] However, SWB rejects AT&T's claim regarding the availability of a low end

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[64] SWB Application at 22 (*citing Illinois Bell v. FCC*, 911 F.2d 776 (D.C. Cir. 1990) (*Illinois Bell*).

[65] AT&T Opposition at 8 (*citing AT&T v. FCC*).

[66] *Id.* at 8 (*citing LEC Price Cap Order*, 5 FCC Rcd at 6802 (para. 127) and Sections 61.3(e) and 61.45(d)(1)(vii) of the Commission's Rules).

[67] *Id.* at 9 (*citing LEC Price Cap Order*, 5 FCC Rcd at 6807 (para. 165). *See also* MCI Opposition at 1, 3-4, 8 (rejecting SWB's reliance on *Illinois Bell* and arguing SWB's lack of expense controls, rather than the Bureau Order, threatens the ability of SWB investors to earn a reasonable return on their investments).

[68] AT&T Opposition at 9 (claiming SWB's Form 492 shows it earned 10.52% in 1990, an amount above the 10.25% low end adjustment mark).

adjustment.[69] Furthermore, SWB claims AT&T's 10.52 percent figure does not properly reflect earnings for the July 1990-June 1991 tariff period.[70]

39. In response to SWB's arguments about underearnings, AT&T observes that underearning alone does not make the applicable rates "unlawful."[71] Noting SWB's concession that in order to qualify for an adjustment under this standard, SWB must demonstrate that its July 1, 1990, rates were unlawfully low, AT&T's claims that SWB fails to make such a demonstration.[72] Instead, in the view of AT&T, SWB attempts to make a collateral attack on the disallowances ordered by the Bureau in SWB's July 1990 rates.[73] MCI also challenges SWB's underearnings claims with its own analysis of SWB's revenue requirements.[74]

B. Discussion

40. We reject SWB's contention that the effect of the price cap rule is confiscatory. SWB has made no showing that supports a finding that it is unable to attract capital. SWB's showing of confiscation consists of an allegation that it expected to earn approximately 9.5 percent

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[69] SWB Reply at 4 (*citing LEC Reconsideration Order*, 6 FCC Rcd at 2691-2692 (paras. 119-121) and claiming no provision has been made for such adjustments for low earnings occurring prior to 1991 and that the absence of a PCI prior to July 1, 1990, would foreclose such relief).

[70] SWB Reply to Oppositions at 5 (claiming that the correct figure for the nine month period ending March 31, 1991, is 9.48%).

[71] AT&T Opposition at 5-6.

[72] *Id.* at 5-6.

[73] *Id.* at 6 (adding that SWB earlier chose not to seek reconsideration of these issues and that SWB's current attempt is untimely and unsupported by sufficient evidence).

[74] MCI Opposition at 5-6. SWB responds to MCI by explaining its calculations in detail and claiming no further adjustments are needed. *See* SWB Reply at 3.

from July 1990 through March 1991.[75] Since it filed its Application, that earnings level has been revised upward by SWB to 10.18 percent.[76] Under rate of return regulation, however, we traditionally measure earnings on the basis of a two-year monitoring period. For the 1989-90 monitoring period, SWB earned 11.73 percent.[77] Under price cap regulation, we measure LEC earnings on calendar year increments. For calendar year 1990, SWB earned 10.5 percent.[78] In the first three quarters of calendar year 1991, SWB earned 11.96%.[79] Moreover, under price cap regulation, SWB has the ability and the incentive to institute productivity gains that will allow it to retain all earnings up to a 13.25 percent rate of return and portions of earnings above that amount. We therefore disagree, on the basis of the information before us, that the price cap rule has resulted in confiscation.

41. In addition, the Bureau Order merely implemented a Commission decision to use July 1, 1990, rates as the base rates for price caps even if those rates reflected some targetting errors. We reject SWB's contention that our decision limits the ability of SWB to earn a reasonable

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[75] *See* SWB Reply at 5.

[76] *See* Letter to Chief, Common Carrier Bureau, FCC, from D. Hubbard, Vice President, SWB, dated Oct. 17, 1991, p. 2.

[77] SWB ARMIS Report 43-01 (Quarterly Report), 4Q1990.

[78] *See* SWB ARMIS Report 43-01 (Quarterly Report), 1Q1990-4Q1990. *See also* SWB FCC Form 492 (Rate of Return Report), for quarters ending Dec. 31, 1989, and 1990.

[79] SWB ARMIS Report 43-01 (Quarterly Report), 3Q1991. On March 31, 1992, SWB filed its initial view of its rate of return for calendar year 1991. Due in large part to SWB's decision, in the fourth quarter of that year, to charge against earnings the cost of an early retirement program, SWB reports an annual rate of return of 10.74%, well above the low-end adjustment mechanism of 10.25%. Absent that charge against earnings, SWB would have reported a return of approximately 11% for that year. SWB FCC Form 492 (Rate of Return Report), for quarter ending Dec. 31, 1991.

rate of return. SWB is incorrect in its contention that use of July 1990 base rates effectively creates a one-way street for LECs subject to price cap regulation. Our decision permits adjustments in base rates if the actual return while under price cap regulation is lower than the projected return in the months leading up to such regulation, provided a carrier can offer sufficient information to withstand the heightened scrutiny for such filings. We note that even under rate of return regulation, there is no guarantee that rates can automatically be retargetted without an examination of costs.

42. There is no evidence that such an approach violates the mandate of *AT&T v. FCC*. As AT&T notes in its Opposition, price cap regulation of the largest LECs can easily be distinguished from the refund mechanism at issue in *AT&T v. FCC*. Price cap regulation includes mechanisms that enable price cap LECs to raise their aggregate rates above the prevailing caps when earnings become excessively low, *e.g.*, the low-end earnings adjustment and the above-cap filing.

V. GAMING ALLEGATION

A. Pleadings

43. SWB claims the Bureau Order unfairly alleges that SWB purposely increased its costs prior to its entry into price cap regulation.[80] While SWB generally argues that its increased costs entitle it to increased rates, it strongly denies that it has purposely increased those costs to "unduly advantage" itself under price cap regulation.[81] SWB claims that the Bureau's findings do not indicate that SWB "gamed" the system by purposely attempting to increase costs in anticipation of price cap regulation, but only that the SWB forecasts underlying its July 1, 1990, rates were

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[80] SWB Application at 10 (*citing Bureau Order*, 6 FCC Rcd at 2090-91).

[81] *Id.* at 10.

too conservative and should now be supplanted with actual data.[82]

44. SWB also asserts that neither the Commission staff nor any petitioners identified any unreasonable cost amounts for SWB.[83] On the contrary, SWB contends that it is actively working to lower its overall costs.[84]

B. Discussion

45. The Bureau Order did not make any finding that SWB "gamed" the introduction of price caps by increasing its costs, and attempting to increase rates, prior to the start of price cap regulation. The Bureau Order simply observed that "on its face" SWB's transmittal raised the issue the Commission sought to avoid when it chose July 1, 1990, as the date from which to initialize price cap indexes. The Commission recognized that LECs might be tempted to increase costs, rates, and index levels in the interim between release of the *LEC Price Cap Order* and the January 1, 1991, changeover date. SWB has not satisfied its burden of showing that the full amount of its requested rate increases is justified.

VI. PROCEDURAL ISSUES

46. SWB claims that the Bureau Letter incorrectly declared Application 257 to be moot. Since the status of Transmittal 2051 was under review by this Commission as a result of the SWB Application for Review, SWB claims the Bureau could not make a final determination as to the "mootness" of Application 257 at that time.[85]

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[82] *Id.* at 11-15.

[83] *Id.* at 19.

[84] *Id.* at 16 (noting its Management Force Adjustment Program as an example of its efforts to reduce expenses).

[85] SWB Request at 3.

47. SWB asks this Commission to consolidate consideration of Application 257 with its consideration of Transmittal 2051.[86] SWB argues that, to the extent the Bureau Order effectively confiscates SWB revenues, the May 15 letter would effectively confiscate more revenues by denying SWB the opportunity to show a larger shortfall.[87]

48. We affirm the Bureau's determination that Application 257 became moot as a result of the Bureau Order rejecting Transmittal 2051. Application 257 presumed the effectiveness of Transmittal 2051 which transmittal was rejected by the Bureau. It merely added some additional months of actual data to the information SWB submitted in Transmittal 2051. It did not, for example, change the calculation of SWB's "subject to separations" factors—those continued to be based on data from a single month (July 1990). Similarly, Application 257 did not alter the changes SWB had made in its basic study separations nor did it change SWB's methodology for calculating demand. As we noted earlier, SWB itself characterizes Application 257 as an "extension" of Transmittal 2051. Accordingly, we find that the Bureau Letter correctly declared Application 257 to be moot in light of the earlier Bureau Order rejecting Transmittal 2051. In any event, we have reviewed the additional data included in Application 257 and, as discussed above, it does not support a grant of the relief requested by SWB.

VII. CONCLUSION AND ORDERING CLAUSES

49. We have examined the SWB Request as well as its Application for Review, the associated oppositions, and the reply to those oppositions filed by SWB. As discussed above, none of the parties raises any issues which would lead us to modify the Bureau Order, except for the correction to SWB's access rates noted earlier.

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[86] *Id.* at 1, 4-5.

[87] *Id.* at 4.

50. Accordingly, IT IS ORDERED, that Southwestern Bell Telephone Company's Application for Review and Request for Consolidation, filed June 14, 1991, IS DENIED.

51. Accordingly, IT IS ORDERED that the Southwestern Bell Telephone Company's Application for Review, filed May 3, 1991, IS GRANTED to the extent noted herein and is otherwise DENIED. Tariff revisions reflecting our limited grant of this Application should be filed on not less than three (3) days' notice.

52. IT IS FURTHER ORDERED that Sections 61.58 and 61.59 of the Commission's Rules, 47 C.F.R. §§ 61.58 and 61.59, ARE WAIVED for the purpose of compliance with this Order and Special Permission No. 92-253 IS ASSIGNED.

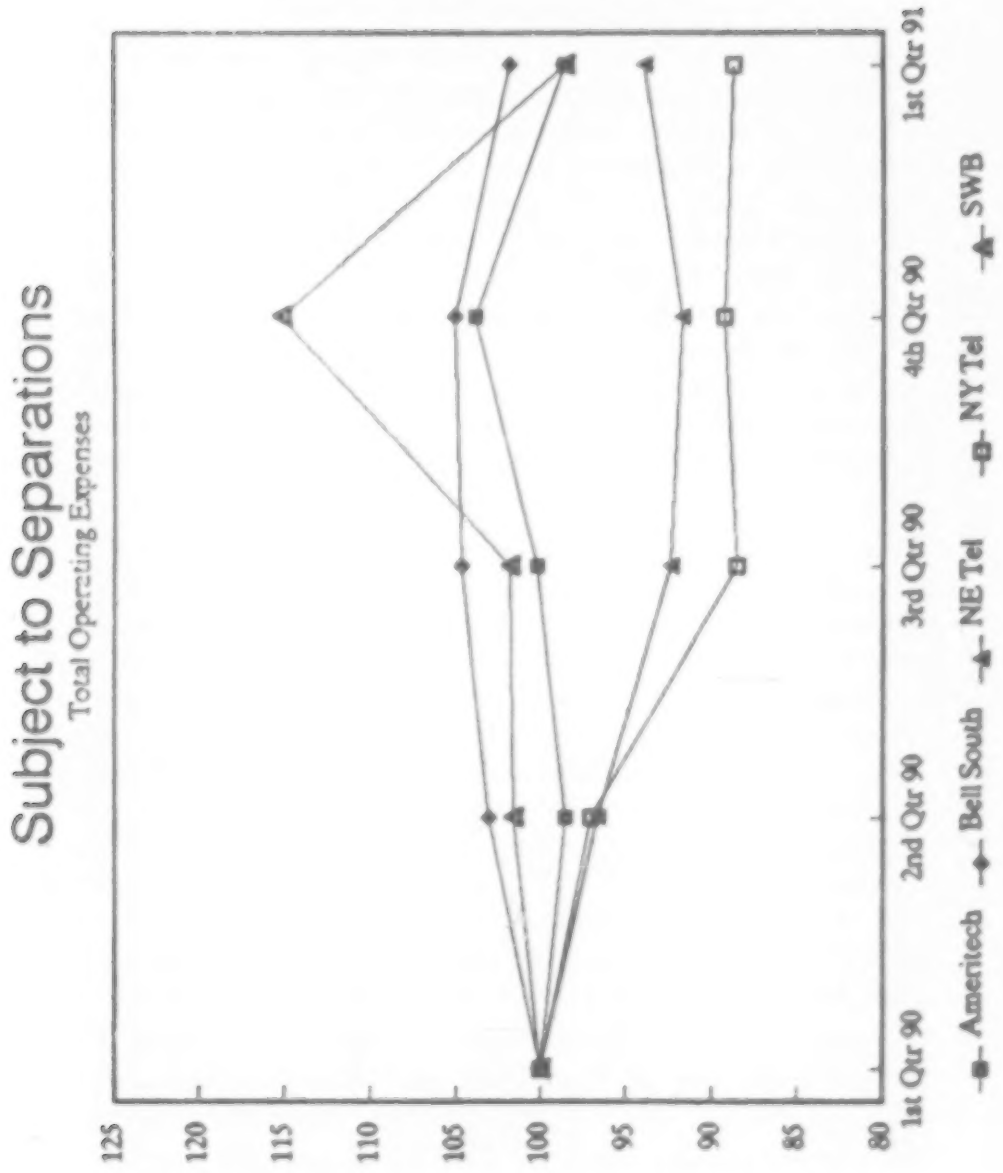
FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

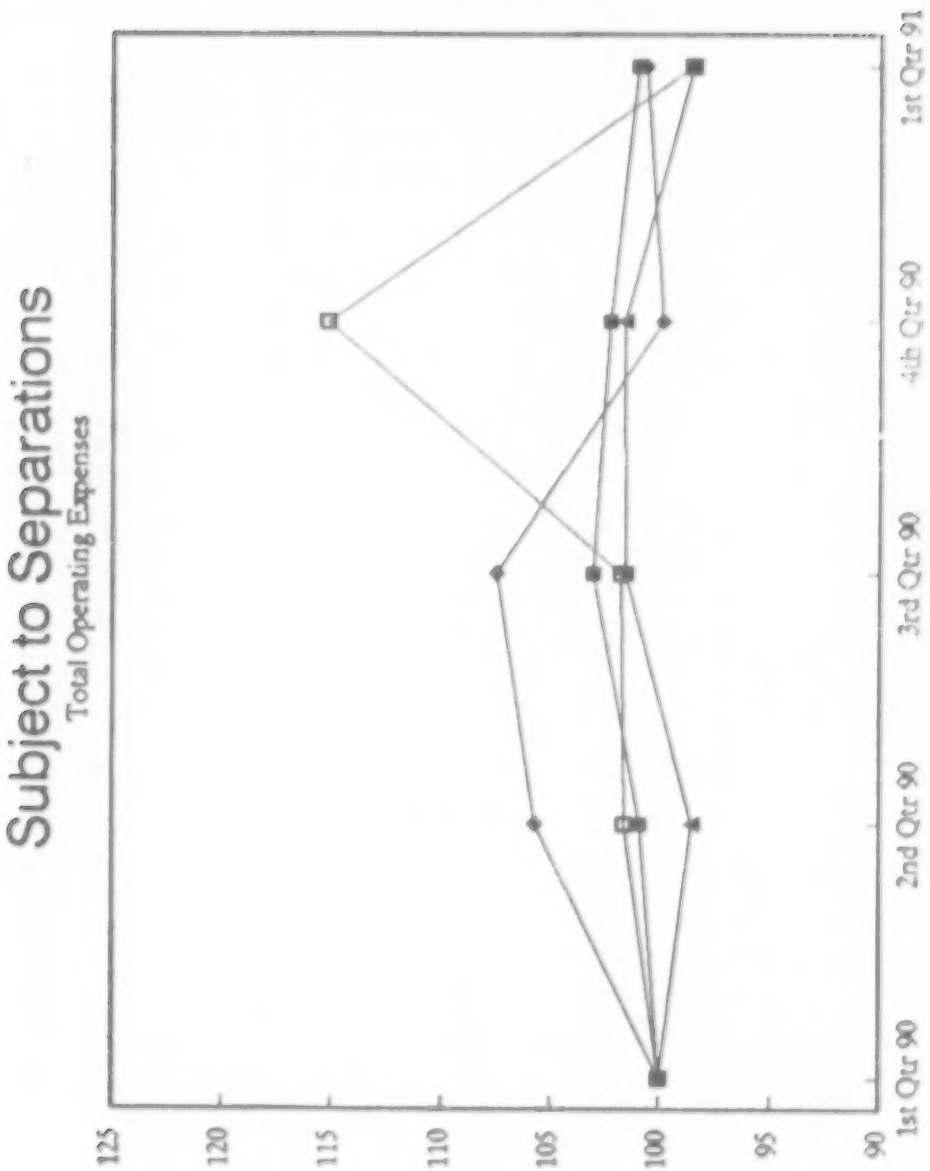
APPENDIX A

SWB Total Operating Expense
Subject to Separations
Thousands
1550
1500
1450
1400
1350
1300
1250
1200
1st Qtr 90
2nd Qtr 90
3rd Qtr 90
4th Qtr 90
1st Qtr 91

APPENDIX B-1


Subject to Separations
Total Operating Expenses
125
120
115
110
105
100
95
90
85
80
1st Qtr 90
2nd Qtr 90
3rd Qtr 90
4th Qtr 90
1st Qtr 91
Ameritech
Bell South
NE Tel
NY Tel
SWB

APPENDIX B-2


Subject to Separations
Total Operating Expenses
125
120
115
110
105
100
95
90
1st Qtr 90
2nd Qtr 90
3rd Qtr 90
4th Qtr 90
1st Qtr 91
Pac Bell
New Bell
US West
SWB

APPENDIX C

Computation of Rate Adjustment

SWB's claim that its expenses for the July 1990 through June 1991 tariff year are within a normal range of growth from the 1988 and 1989 tariff years appears to be contradicted by the historical trend growth rate in unseparated expenses less depreciation (ELD) which was computed in the review of the 1990 annual access filings. In that review, the Bureau computed linear trend models from each Tier 1 local exchange carrier's (LEC's) own ELD data for the first quarter of 1986 through the fourth quarter of 1989. For SWB, those data showed a trend growth rate of -1.81 percent, i.e, that SWB's expenses actually declined over time, whereas SWB was projecting a 2.8 percent increase.

LECs were allowed to vary from their historical trend growth rates by an amount which depended on the accuracy of their ELD forecasts in previous annual access filings. Because of SWB's poor record at forecasting ELD accurately in previous annual filings, an initial disallowance was identified that reflected a growth rate which differed from SWB's historical trend growth rate by one standard deviation. However, this disallowance would have allowed SWB's ELD to grow by less than the nationwide average growth rate for Tier 1 LECs. No carrier, including SWB, had its ELD forecast adjusted below the national average growth rate of 1.3 percent, and SWB's trend ELD disallowance of $16.02 million reflected that nationwide average growth rate.

Further review of the data used in the trend model indicates that the primary cause for the negative growth rate was that the ELD data dropped significantly in the first quarter of 1987 due to certain one-time expenses in 1986.[1] Inclusion of these one-time expenses in estimat-

[1] SWB has indicated that the main causes of its higher ELD in 1986 were a management force reduction program and its takeback

ing the trend would give an incorrect picture of the underlying year-to-year change in SWB's ELD data. Because we do not have the data to adjust each SWB quarter in 1986, we exclude the 1986 data from the trend analysis and calculate a trend growth rate of 2.56 percent. With this trend growth rate, SWB's projected ELD for the 1990 tariff year falls within one standard deviation of the trend growth rate, and no disallowance would have been made based on the trend analysis. However, a $9.15 million ELD disallowance, identified by the cross section analysis of ELD in the 1990 annual access filing, would have been made.

Based on this adjustment to the Bureau's analysis, SWB is permitted to raise its rates by the difference between these two amounts, or $6.87 million.[2] Adjusting the disallowances in this manner is consistent with the Bureau's treatment of the trend disallowances for Telephone Plant in Service (TPIS) in the *1990 Annual Access Order*. Where significant anomalies were identified with carrier's trend data, the Bureau adjusted the TPIS trend disallowances. Examples of this are Diamond States and New Jersey Bell. In addition, the Bureau performed its TPIS trend regressions on shortened time periods for several LECs because of significant shifts in the data.[3]

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of operator services from AT&T. *See* Letter to Chief, Tariff Division, Common Carrier Bureau, FCC, from W. Blase, Director—Federal Regulatory, SWB, dated November 15, 1991.

[2] Of this amount, $4.8 million goes to common line, $1.466 million goes to traffic sensitive-switched, and $0.604 million goes to special access.

[3] The companies were Centel of Nevada, Southern New England Telephone Company, the United Telephone Companies of North Carolina, Ohio, Pennsylvania, and United Inter-Mountain. See Chart TPISDIS, page 1 of 5, Appendix C, *1990 Annual Access Order*.

SEPARATE STATEMENT OF COMMISSIONER ANDREW C. BARRETT DISSENTING IN PART

Re: In the Matter of Southwestern Bell Telephone Company's Application for Review

I have carefully weighed my decision on this Memorandum Opinion and Order (Order) concerning Southwestern Bell Telephone Company's (SWB) mid-course correction request. SWB has asked the Commission to reverse the Bureau's Order and allow it to increase its access rates by 65.9 million dollars. The Commission's Order affirms the Bureau's rejection of SWB's request with one minor exception. This Order does allow SWB to make a 6.87 million correction to its July 1, 1990 access rates and associated adjustments to SWB's price cap indexes.

After reviewing the various factors cited in this Order, I support the 6.87 million adjustment to SWB's July 1, 1990 base rates. SWB's 1986 data reflected a large one-time only expense which skews the Bureau's trend analysis used in the 1990 Access Order. Since we have in the past traditionally corrected for anomalous data points, the adjustment is warranted.

However, I am deeply concerned with other more central issues raised in this item. Both from a policy and legal perspective, the review of SWB's mid-course correction raises many factual questions. I must question the Order's heavy reliance on the *LEC Price Cap Order* in treating this mid-course correction. In particular, the *LEC Price Cap Order* was not explicit on how mid-course corrections would be treated on the eve of price caps; nor, did it state what more stringent cost criteria, if any, would be applicable in such instances.[1]

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[1] *See Second Report and Order* in CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) and Erratum, 5 FCC Rcd 7664 (1990) (*LEC Price Cap Order*), *modified on recon.*, 6 FCC Rcd 2637 (1991), *petitions for further recon. pending, appeal docketed, D.C. PSC v. FCC*, No. 91-1279 (D.C. Cir. June 14, 1991).

As discussed below, the facts surrounding this issue raise many concerns. First, it appears that the Commission for the first time articulates a new more stringent standard for these type filings.[2] The Order notes that the Commission "implicitly" suggested review of mid-course corrections under more stringent criteria than those traditionally prevailing under rate of return.[3] However, nowhere do I find that SWB was given explicit notice that it would be held to a more stringent standard when it filed its mid-course correction or afterwards. Nor can I find any articulation of the heightened standard to be applied. Instead, SWB received a waiver of Section 61.38 (b)(1). Letter to SWB, from J. Cimko, Chief, Tariff Division, Common Carrier Bureau, FCC, dated Nov. 29, 1990. This waiver of the cost support data was granted subsequent to the Commission's release of the *LEC Price Cap Order*.[4] Although the waiver did not, as the Commission's Order notes, constitute approval of the proposed filing, it may have provided SWB with an understanding that its mid-course correction would not be subjected to the heightened review standard the Commission now articulates in this Order. Interestingly, the Common Carrier Bureau's Order specifically noted that the "Tariff Division has normally refrained from granting special permission to omit some of the data required by Section 61.38 of the Commission's Rules." [5]

To hold SWB to a new heightened scrutiny without notice to SWB is patently unfair. SWB is accused of

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[2] *See* Order at § 19.

[3] *Id.* Cf. Cincinnati Bell Telephone Company, Revisions to Tariff F.C.C. No. 353, Transmittal No. 600, 6 FCC Rcd 7538 (Com. Car. Bur. 1991) (Common Carrier Bureau waived costs support data and permitted mid-course correction).

[4] *LEC Price Cap Order*, 5 FCC Rcd 6786 (1990).

[5] Southwestern Bell Telephone Company, Revisions to Tariff F.C.C. No. 68, Transmittal No. 2051, 6 FCC Rcd 2089, 2091 (Com. Car. Bur. 1991).

providing insufficient cost support data, but until this Order it never has been made fully aware of what the Commission required. SWB, even with a waiver of the rules provided data and explanation in support of its filing. I believe the Commission should have provided SWB with an opportunity to formally comply with the new cost support criteria. In the absence of such *explicit* notice, I cannot support this portion of the Order. I must therefore dissent on this latter issue but do support the allowed 6.87 million adjustment to SWB's July 1990 base rates.

APPENDIX E

FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

15 May 1991

In Reply Refer To:
61610

Southwestern Bell Telephone
1667 K Street, N.W.
Suite 1000
Washington, DC 20036

Attention: William A. Blase, Jr.
Director-Federal Regulatory

Re: Application No. 257, March 22, 1991
Southwestern Bell Telephone Company
Tariff F.C.C. No. 68

Dear Mr. Blase:

Reference is made to the above application in which you request a waiver of Sections 61.38(b)(1) and 61.41 of the Commission's Rules, 47 C.F.R. §§ 61.38(b)(1), 64.41, in order to further revise the rates which your Company proposed in the tariff revisions it filed under Transmittal No. 2051, on December 4, 1990.

On April 9, 1991 the Common Carrier Bureau released an Order [1] rejecting the tariff revisions submitted under your Company's Transmittal No. 2051. Therefore, Application No. 257 is now considered moot; and your request for waiver of the above mentioned Rules is hereby dismissed.

Sincerely,

/s/ John Cimko
JOHN CIMKO
Chief, Tariff Division
Common Carrier Bureau

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[1] In the Matter of Southwestern Bell Telephone Company Revisions to Tariff F.C.C. No. 68, Transmittal No. 2051, *Order*, released April 9, 1991, DA 91-470.

APPENDIX F

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Transmittal No. 2051

IN THE MATTER OF
SOUTHWESTERN BELL TELEPHONE COMPANY
Revisions to Tariff F.C.C. No. 68

ORDER

Adopted: April 9, 1991 Released: April 9, 1991

By the Chief, Common Carrier Bureau:

I. INTRODUCTION

1. On December 4, 1990, Southwestern Bell Telephone Company (SWB) filed Transmittal No. 2051, a mid-course submission to retarget its price cap rates to earn the authorized rate of return (ROR) for the remainder of the July 1990 through June 1991 tariff period. On December 19, 1990, MCI Telecommunications Corporation (MCI) and US Sprint Communications Company Limited Partnership (Sprint) filed separate petitions to reject, or in the alternative, suspend and investigate, and American Telephone and Telegraph Company (AT&T) filed a petition to suspend and investigate. SWB filed its reply on December 31, 1990. Transmittal 2051 is scheduled to become effective on April 10, 1991. For the reasons discussed below, we reject Transmittal 2051.

II. BACKGROUND

2. On November 1, 1990, SWB, along with the other local exchange carriers (LECs) subject to mandatory price cap regulation under the *LEC Price Cap Order*,[1] filed its initial price cap rates, effective January 1, 1991.[2] In accordance with the requirements of the *LEC Price Cap Order*, SWB used its interstate access rates as they existed on July 1, 1990 as the starting point for its price indexes under price cap regulation.[3]

3. Transmittal 2051 would revise the base rates that SWB used to develop its initial price cap rates. SWB argues that the July 1, 1990 rates are not appropriate as the starting point for price caps since those rates fail to produce the authorized ROR for the July 1, 1990 through June 30, 1991 tariff period ("tariff period"). SWB says a modification of those rates is necessary to avoid a continuation of built-in underrecovery during the entire four-year initial price cap period. Description and Justification (D&J) at Section 1.

4. Based on actual revenues from July 1990 through October 1990 and estimates for November 1990 through

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[1] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990) (*LEC Price Cap Order*), *recon. pending. See also* Commission Requirements for Cost Support Material to be Filed with January 1, 1991 Access Tariff Revisions, 5 FCC Rcd 6480 (Com. Car.Bur. 1990) (*TRP Order*).

[2] Southwestern Bell Telephone Company, Tariff F.C.C. No. 68, Transmittal No. 1970, filed Apr. 2, 1990.

[3] *See* Annual 1990 Access Tariff Filings, CC Docket No. 90-320, Memorandum Opinion and Order, 5 FCC Rcd 4177 (Com.Car.Bur. 1990) (*1990 Annual Access Order*); Annual 1990 Access Tariff Filings, CC Docket No. 90-320, Order, 5 FCC Rcd 4142 (Com.Car. Bur. 1990) (*1990 Annual Access Order Revisions*); Annual 1990 Access Tariff Filings, CC Docket No. 90-320, Memorandum Opinion and Order, 5 FCC Rcd 6015 (Com.Car.Bur. 1990) (*1990 Annual Access Order Erratum*).

June 1991, SWB projects that it will have a ROR of 10.83 percent if current rates remain in effect, while the authorized, blended ROR is 11.62 percent.[4] According to SWB, this represents a $37.6 million revenue shortfall for the tariff period.[5]

5. SWB's revenue requirements for July through December 1990 were developed by multiplying the actual data for July through October by two. *Id.* at Section 2.A.3. Estimates for January through June 1991 are based on SWB's Operational Budget View for 1991. *Id.* at Section 2.A.4. Revenues for the tariff period were developed based on four months of actual data and projected data for the remaining months. Relationships between originating and terminating-rated Common Line (CL) minutes and revenue were developed using a new comprehensive database of billed and earned demand and revenue developed by SWB. Carrier Common Line (CCL) revenues were computed for originating and terminating, premium and non-premium minutes of use based on the revised forecasted demand. *Id.* at Section 2.B.

6. SWB calculated rate adjustment factors (RAF) for the Traffic Sensitive and Special Access Price Cap basket rates. SWB applied these RAFs to the July 1, 1990 rates to develop new July 1, 1990 starting point

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[4] The authorized ROR for LECs was lowered from 12 percent to 11.25 percent beginning January 1, 1991. As a result, the authorized level for the entire tariff period, from July 1990 through June 1991, is a blend of these two figures. *See* Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order, 5 FCC Rcd 7507 (1990).

[5] Subsequent to the filing of Transmittal 2051, SWB revised its projections, and now, based on six months of actual data, it anticipates a $64.2 million shortfall for the tariff period, resulting in a 10.3 percent ROR. Letter to Chief, Common Carrier Bureau, FCC, from D.T. Hubbard, Vice President, Southwestern Bell Telephone Company, dated Mar. 11, 1991.

rates for the 11.25 percent ROR represcription adjustment and the initialization of price cap rates. *Id.* at Section 3.C. SWB also used the revised July 1, 1990 rates as the basis of the Actual Price Index (API) and Service Band Index (SBI) weightings, as well as the initialization of the indexes to 100. SWB calculated revised January 1, 1991 Price Cap Indexes (PCIs) based on the revised July 1, 1990 rates and the represcription, which was treated as an exogenous cost. *Id.* at Section 5.

III. PLEADINGS

A. Petitions

7. AT&T doubts that any adjustment to SWB's rates is required. AT&T argues that since SWB will earn a 11.17 percent ROR for the January 1991 through June 1991 period, which is close to the authorized 11.25 percent ROR for that period, SWB's underearnings would be less than $1.3 million. AT&T Petition at 4-5. According to AT&T, forecasting variations of that size are not unusual, and SWB's forecast is being made on an extremely small amount of data. *Id.* at 5. AT&T also notes that SWB has consistently underforecasted its earnings in the past. *Id.* at 5 n.***. Finally, AT&T complains that SWB did not take into account the effects of demand stimulation due to lower end user rates from the interexchange carriers. *Id.* at 6.

8. Sprint complains that the rate increase is premature, unjustified, and constitutes retroactive ratemaking. First, Sprint argues that it is premature to reset initial price cap rates based on only three to four months of actual data, and that SWB should wait until it has at least six months of data before reassessing its rates.[6] Sprint Petition at 2. In any event, Sprint believes that SWB should only be allowed to adjust its rates to earn a 10.25 percent ROR.

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[6] SWB now has submitted projections based on six months of data. *See* note 5, *supra*.

Id. at 3. Second, Sprint states that SWB's projections are highly questionable. Sprint claims that the magnitude of the change in size of the revenue requirements between the first and second halves of the tariff period, which SWB estimates to more than double, is so dramatic as to cast serious doubt over its validity. *Id.* at 3-4. Sprint also argues that it is not clear which revenue requirements that the Commission disallowed in the *1990 Annual Access Order* that SWB believes were inappropriate and why the Commission should reinstate them now. *Id.* at 4. Finally, Sprint believes that SWB is trying to earn the entire $37.6 million shortfall in the remainder of the rate period, which would be retroactive ratemaking. *Id.* at 5.

9. MCI alleges that SWB is attempting to make a unilateral change in the starting point for price caps. MCI Petition at 3. MCI asserts that Transmittal 2051 violates the *LEC Price Cap Order* in two ways. First, according to MCI, that Order explicitly found the July 1, 1990 rates to be just and reasonable. MCI notes that the Order contemplated rate adjustments by LECs by allowing them so long as the rates effective January 1, 1991 were at or below the Price Cap Indexes (PCIs). *Id.* at 4. MCI argues that SWB's transmittal violates that rule and should be considered an above-cap filing. *Id.* at 5. Second, MCI states that the Order provided appropriate relief for LECs which underearn, noting that Section 61.45(d)(1)(vii) of the Commission's Rules, 47 C.F.R. § 61.45(d)(1)(vii), allows LECs that are earning under 10.25 percent ROR to adjust their rates to earn at that level. *Id.* at 5.

10. Further, MCI claims that SWB's revenue analysis is fatally flawed, and that instead of having an underrecovery, SWB's current rates will lead to an overrecovery. *Id.* at 7-8. MCI states that it recalculated SWB's semi-annual revenue requirements for the January 1991 through June 1991 period with two adjustments to SWB's

estimates—MCI reduced the impact of the 1991 accounting changes by one-half and used the correct revenue figures for that period—and found that SWB would overearn by $6.4 million for the six months, or more than $12.7 million on an annual basis. *Id.* at 8-9.

11. MCI states that this discrepancy is due to three basic flaws in SWB's analysis. First, MCI complains that SWB made no attempt to determine what revenues it expected to receive in each half of the tariff period, but simply assumed it will receive revenues in each half in an amount equal to its semi-annual revenue requirement. *Id.* at 9. Second, according to MCI, SWB double counted the effects of the separations and accounting changes that became effective January 1, 1991. Third, MCI claims that SWB used the wrong revenue figures to calculate its ROR for the January 1991 through June 1991 rate period. *Id.* at 10.

B. SWB Reply

12. SWB responds that Transmittal 2051 is not an attempt to avoid the risks associated with price cap regulation, but only seeks to ensure that SWB starts with the proper rates. SWB Reply at 8. SWB argues that the Commission assumed the July 1, 1990 rates were a reasonable starting point for price caps because the Commission assumed that under those rates a LEC would earn the authorized ROR. That assumption was wrong for SWB, however, since the data show that SWB will not earn the authorized ROR with those rates. *Id.* at 2. Indeed, SWB increased its projected shortfall by $7.69 million, based on its actual costs for October 1990.[7] *Id.* at 5-6. Thus, SWB argues that the Commission should recognize that the Commission earnings assumptions were invalid and allow SWB to correct its rates. *Id.* at 3. SWB also argues that the low end adjustment mechanism

[7] SWB has further revised this figure based on six months of actual data. *See* note 5, *supra*.

discussed by MCI and Sprint was not meant as a remedy for dealing with problems with initial price cap rates, and its use would impose an unfair penalty on SWB. *Id.* at 8.

13. SWB contends that AT&T misunderstands the 11.17 percent ROR figure. According to SWB, 11.25 percent is not a proper benchmark since the separations and accounting changes did not become effective until January 1, 1991. *Id.* at 12. Given that the rates were set for the entire rate period, and thus were set to underearn in the first half and overearn in the second half, SWB states that the appropriate ROR for the January 1991 through June 1991 period is 12.26 percent, which results in a revenue shortfall of $25.8 million for SWB. *Id.* at 13. Regarding AT&T's other argument, SWB states that the National Exchange Carrier Association (NECA) calculates that demand stimulation from the interexchange carriers' lower end user rates will account for only $1 million over the six month period in question. *Id.* at 19-20.

14. Concerning Sprint's assertion that SWB is proposing retroactive ratemaking, SWB explains that while it is giving shortfall amounts on an annual basis, it is only seeking to adjust its rates on an ongoing basis. *Id.* at 9. SWB also argues that it is not contesting the Commission disallowances or asking the Commission to change its mind. Those disallowances were based on data before the Commission at that time, and SWB is now presenting the Commission subsequently available actual data and new estimates derived from that data. *Id.* at 10-11.

15. Finally, SWB contends that MCI erred in its analysis of SWB's revenues and costs. First, SWB states that it did not simply assume that SWB will receive revenues in each half of the tariff period in an amount equal to its semi-annual revenue requirement. Rather, SWB argues that revenue levels do not change over the tariff period because of accounting and separation changes, since those changes are averaged over the entire period when

the rates are established. *Id.* at 17. Second, SWB denies that it double counted the effects associated with the separations and accounting changes. SWB states that the adjustment it made simply shows the out-of-period recovery that is expected due to incorporating approximately 50 percent of the 1991 accounting and separations effects and the deviations it causes from authorized ROR. *Id.* at 18-19. Third, SWB claims that it did use the correct revenue estimates in its calculations, but that MCI used the estimates from the July 1, 1990 rates, which have been subsequently lowered due to represcription. *Id.* at 14.

IV. DISCUSSION

16. After reviewing Transmittal 2051, the Description and Justification supporting it, the petitions against it, and SWB's reply comments, we conclude that this transmittal must be rejected. We find that SWB's adjustments to its initial price cap rates and indexes are not allowed by the Commission's price cap regulations and violate the *LEC Price Cap Order.*

17. In establishing the price cap rules for the LECs, the Commission concluded that July 1, 1990 rates provided the most reasonable basis for developing initial price cap rates and indexes. *LEC Price Cap Order*, 5 FCC Rcd at 6814 (para. 230). The Commission noted that these rates had been subjected to six years of effort to reform rate of return regulations and noted the type of analysis that these rates went through before the rates became effective. *Id.* at 6815-16 (paras. 233-40).

18. Another important factor in the Commission's decision to use the July 1, 1990 rates was the desire to use an historical date, rather than a prospective one. The Commission chose rates which had already been set to prevent LECs from engaging in any aggregate price increases in the period leading up to price caps. The Commission used this same mechanism when the Commission established price cap regulation for AT&T. *Id.* at 6814

(para. 231). The Commission was concerned that, in the period leading up to price cap regulation, LECs would have strong incentives to increase their rates in a rate of return environment by increasing their costs. These incentives, always present under ROR regulation, would be heightened because the higher the initial price cap rates, the easier it would be for the LECs to cut their costs and increase their rate of return in the initial four-year price cap period. The Commission established the July 1, 1990 rates as base rates in order to avoid giving LECs the wrong incentives.

19. In applying these conclusions to Transmittal 2051, we find that SWB, subsequent to its submission of July 1, 1990 rates, has decided that it will experience greater costs than it previously estimated for the tariff period. Thus, on its face, SWB's transmittal raises the exact issue the Commission addressed when it decided to use July 1, 1990 rates as the starting point for price cap regulation. Furthermore, since the Commission has not guaranteed that those rates will earn the authorized ROR, there is no need for adjustment. The greater rewards available under price cap regulation also pose greater risk; SWB's principal remedy for underearning is to control its costs and stimulate demand. *See id.* at 6794-95 (paras. 65-69).

20. The *LEC Price Cap Order* does not suggest that the Commission expected to adjust the July 1 rates to fine tune rates to the authorized ROR level.[8] Such routine exogenous treatment would have created the kind of incentives the Commission sought to avoid. The *LEC Price Cap Order* does, however, imply that exogenous treatment could be granted in extraordinary circumstances.[9] SWB has not demonstrated extraordinary cir-

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[8] SWB acknowledges that its expected revenues will exceed the revenue requirements allowed by the Commission by almost a half million dollars. D&J at Section 2.

[9] In the Order the Commission stated: "since we decided to conduct a full access filing for July 1, 1990, mid-course corrections

cumstances that could arguably justify exogenous treatment.

21. The midcourse filing is based in substantial part upon the implementation of new separations studies that produce a larger allocation of costs to interstate services than SWB anticipated at the time SWB prepared its tariffs for the July 1990-June 1991 access year. The *LEC Price Cap Order* specified that cost changes resulting from a change in the jurisdictional separations rules would be treated as exogenous cost changes for purposes of computing price caps. Those changes do not include new studies based upon unchanged allocations rules. Therefore, exogenous treatment for this kind of cost change is inconsistent with the *LEC Price Cap Order*.

22. Moreover, it appears doubtful that this midcourse would have been accepted in the absence of additional cost justification even if the price caps rules had not been adopted. The Tariff Division has normally refrained from granting special permission to omit some of the data required by Section 61.38 of the Commission's Rules, 47 C.F.R. § 61.38, if a midcourse revision was based upon newly introduced separations studies that were not subject to examination in the last annual access filing. Consequently, if this filing were processed in accordance with prior practice, we would be obligated to reject the transmittal for failure to comply with Section 61.38 cost support requirements.

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during the six-month period leading up to price caps are likely to be premature. We will not give any such correction routine exogenous treatment." *LEC Price Cap Order*, 5 FCC Rcd at 6848, n.315.

Thus, exogenous treatment would be necessary to enable us to accept the transmittal. In the absence of a decision to classify the projected revenue requirement changes as a change in exogenous costs, however, SWB's filing, which reestablishes index levels as of July 1, 1990 for the Price Cap Indexes and Actual Price Indexes, amounts to an unjustified above cap filing.

23. Inasmuch as SWB has not provided adequate justification for these rate increases under either the prior rate of return procedures or the new price cap procedures, this transmittal must be rejected.

V. ORDERING CLAUSES

24. Accordingly, IT IS ORDERED that Southwestern Bell Telephone Company, Tariff F.C.C. No. 68, Transmittal No. 2051 IS REJECTED.

25. IT IS FURTHER ORDERED that Southwestern Bell Telephone Company SHALL ISSUE revisions to the tariff no later than five business days from the release of this Order removing the rejected material from its tariff. These revisions shall be scheduled to become effective on one day's notice.

26. IT IS FURTHER ORDERED that Special Permission No. 91-275 IS ASSIGNED and Sections 61.58 and 61.59 of the Commission's Rules, 47 C.F.R. §§ 61.58, 61.59, ARE WAIVED for the purposes of issuing the above revisions.

27. IT IS FURTHER ORDERED that the petitions against Southwestern Bell Telephone Company, Tariff No. 68, Transmittal No. 2051, filed by MCI Telecommunications Corporation, US Sprint Communications Company Limited Partnership, and American Telephone and Telegraph ARE GRANTED to the extent discussed herein, and otherwise ARE DENIED.

FEDERAL COMMUNICATIONS COMMISSION

Richard M. Firestone
Chief, Common Carrier Bureau

APPENDIX G

FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

29 Nov. 1990

In Reply Refer To:
61610

Southwestern Bell Telephone
1667 K Street, N.W.
Suite 1000
Washington, DC 20006

Attention: William A. Blase, Jr.
Director-Federal Regulatory

Re: Application No. 240, November 26, 1990
Southwestern Bell Telephone
Tariff F.C.C. No. 68

Dear Mr. Blase:

The Common Carrier Bureau has determined that a grant of the above application is justified except for your request for a waiver of 47 C.F.R. § 61.58. This will enable you to file the tariff material as requested there on the statutory notice period. For this purpose, we assign Special Permission No. 90-1245 and waive 47 C.F.R. §§ 61.38(b)(1) and 61.59.

This grant does not constitute approval by the Commission or Chief, Common Carrier Bureau of the proposed filing, and does not prejudice any subsequent action which the Commission or Bureau may take.

Sincerely,

/s/ John Cimko
JOHN CIMKO
Chief, Tariff Division
Common Carrier Bureau

APPENDIX H

47 C.F.R. § 61.38 (1992)

§ 61.38 Supporting information to be submitted with letters of transmittal.

(a) *Scope.* This section applies to dominant carriers whose gross annual revenues exceed $500,000 for the most recent 12 month period of operations or are estimated to exceed $500,000 for a representative 12 month period. Local exchange carriers serving 50,000 or fewer success [sic] lines in a given study area that are described as subset 3 carriers in § 69.602 may submit Access Tariff filings for that study area pursuant to either this section or § 61.39. However, the Commission may require any carrier to submit such information as may be necessary for a review of a tariff filing. This section (other than the preceding sentence of this paragraph) shall not apply to tariff filings proposing rates for services identified in § 61.42(a), (b), (d), (e), and (g), promotional offerings that relate to services subject to price cap regulation, or to tariff filings, other than promotional filings, filed on 14 days notice pursuant to § 61.58(c)(6).

(b) *Explanation and data supporting either changes or new tariff offerings.* The material to be submitted for a tariff change which affects rates or charges or for a tariff offering a new service, must include an explanation of the changed or new matter, the reasons for the filing, the basis of ratemaking employed, and economic information to support the changed or new matter.

(1) For a tariff change the carrier must submit the following, including complete explanations of the bases for the estimates.

(i) A cost of service study for all elements for the most recent 12 month period;

(ii) A study containing a projection of costs for a representative 12 month period;

(iii) Estimates of the effect of the changed matter on the traffic and revenues from the service to which the changed matter applies, the carrier's other service classifications, and the carrier's overall traffic and revenues. These estimates must include the projected effects on the traffic and revenues for the same representative 12 month period used in (ii) above.

(2) For a tariff filing offering a new service, the carrier must submit the following, including complete explanations of the bases for the estimates.

(i) A study containing a projection of costs for a representative 12 month period; and

(ii) Estimates of the effect of the new matter on the traffic and revenues from the service to which the new matter applies, the carrier's other service classifications, and the carrier's overall traffic and revenues. These estimates must include the projected effects on the traffic and revenues for the same representative 12 month period used in paragraph (b)(2)(i) of this section.

(c) *Working papers and statistical data.* (1) Concurrently with the filing of any tariff change or tariff filing for a service not previously offered, the Chief, Tariff Review Branch must be provided two sets of working papers containing the information underlying the data supplied in response to paragraph (b) of this section, and a clear explanation of how the working papers relate to that information.

(2) All statistical studies must be submitted and supported in the form prescribed in § 1.363 of the Commission's Rules.

(d) *Form and content of additional material to be submitted with certain rate increases.* In the circumstances set out in paragraphs (d)(1) and (2) of this sec-

tion, the filing carrier must submit all additional cost, marketing and other data underlying the working papers to justify a proposed rate increase. The carrier must submit this information in suitable form to serve as the carrier's direct case in the event the rate increase is set by the Commission for investigation.

(1) Rate increases affecting single services or tariffed items.

(i) A rate increase in any service or tariffed item which results in more than $1 million in additional annual revenues, calculated on the basis of existing quantities in service, without regard to the percentage increase in such revenues; or

(ii) A single rate increase in any service or tariffed item, or successive rate increases in the same service or tariffed item within a 12 month period, either of which results in:

(A) At least a 10 percent increase in annual revenues from that service or tariffed item, and

(B) At least $100,000 in additional annual revenues, both calculated on the basis of existing quantities in service.

(2) Rate increases affecting more than one service or tariffed item.

(i) A general rate increase in more than one service or tariffed item occurring at one time, which results in more than $1 million in additional revenues calculated on the basis of existing quantities in service, without regard to the percentage increase in such revenues; or

(ii) A general rate increase in more than one service or tariffed item occurring at one time, or successive general rate increases in the same services or tariffed items occurring within a 12 month period, either of which results in:

(A) At least a 10 percent increase in annual revenues from those services or tariffed items, and

(B) At least $100,000 in additional annual revenues, both calculated on the basis of existing quantities in service.

(e) *Submission of explanation and data by connecting carriers.* If the changed or new matter is being filed by the issuing carrier at the request of a connecting carrier, the connecting carrier must provide the data required by paragraphs (b) and (c) of this section on the date the issuing carrier files the tariff matter with the Commission.

(f) *Copies of explanation and data to customers.* Concurrently with the filing of any rate for special construction (or special assembly equipment and arrangements) developed on the basis of estimated costs, the offering carrier must transmit to the customer a copy of the explanation and data required by paragraphs (b) and (c) of this section.

[49 FR 40869, Oct. 18, 1984, as amended at 53 FR 36289, Sept. 19, 1988; 54 FR 19841, May 8, 1989; 55 FR 42382, Oct. 19, 1990; 56 FR 55239, Oct. 25, 1991]

47 C.F.R. §§ 61.41-49 (1992)

§ 61.41 Price cap requirements generally.

(a) Sections 61.42 through 61.49 shall apply as follows:

(1) To dominant interexchange carriers, as specified by Commission order;

(2) To such local exchange carriers as specified by Commission order, and to all local exchange carriers, other than average schedule companies, that are affiliated with such carriers; and

(3) On an elective basis, to local exchange carriers, other than those specified in paragraph (a)(2) of this

section, that are neither participants in any Association tariff, nor affiliated with any such participants, except that affiliation with average schedule companies shall not bar a carrier from electing price cap regulation provided the carrier is otherwise eligible.

(b) If a telephone company, or any one of a group of affiliated telephone companies, files a price cap tariff in one study area, that telephone company and its affiliates, except its average schedule affiliates, must file price cap tariffs in all their study areas.

(c) The following rules apply to telephone companies subject to price cap regulation, as that term is defined in § 61.3(w), which are involved in mergers, acquisitions, or similar transactions.

(1) Any telephone company subject to price cap regulation that is a party to a merger, acquisition, or similar transaction shall continue to be subject to price cap regulation notwithstanding such transaction.

(2) Where a telephone company subject to price cap regulation acquires, is acquired by, merges with, or otherwise becomes affiliated with a telephone company that is not subject to price cap regulation, the latter telephone company shall become subject to price cap regulation no later than one year following the effective date of such merger, acquisition, or similar transaction and shall accordingly file price cap tariffs to be effective no later than that date in accordance with the applicable provisions of this part 61.

(3) Notwithstanding the provisions of § 61.41(c)(2) above, when a telephone company subject to price cap regulation acquires, is acquired by, merges with, or otherwise becomes affiliated with a telephone company that qualifies as an 'average schedule' company, the latter company may retain its 'average schedule' status or become subject to price cap regulation in accordance with § 69.3(i)(3) and the requirements referenced in that section.

(d) Local exchange carriers that become subject to price cap regulation as that term is defined in § 61.3(w) of this chapter shall not be eligible to withdraw from such regulation.

[55 FR 42382, Oct. 19, 1990; 55 FR 50558, Dec. 7, 1990, as amended at 56 FR 55239, Oct. 25, 1991]

§ 61.42 Price cap baskets and service categories.

(a) Each dominant interexchange carrier subject to price cap regulation shall establish three baskets as follows:

(1) A residential and small business services basket;

(2) An 800 service basket; and

(3) A business services basket.

(b)(1) The residential and small business basket shall contain such services as the Commission shall permit or require, including the following service categories:

(i) Domestic day MTS;

(ii) Domestic evening MTS;

(iii) Domestic night/weekend MTS;

(iv) International MTS;

(v) Operator and credit card services; and

(vi) Reach Out America.

(2) The 800 service basket shall contain such services as the Commission shall permit or require, including the following service categories:

(i) Readyline 800;

(ii) AT&T 800;

(iii) Megacom 800;

(iv) Other 800; and

(v) 800 Directory Assistance.

(3) The business services basket shall contain analog private line offerings, including analog voice grade private line and terrestrial television transmission service.

(c) Dominant interexchange carriers subject to price cap regulations shall exclude the following offerings from their price cap baskets:

(1) Special construction services relating to services in § 61.42(b)(1), (b)(2), and (b)(3);

(2) All other special construction services;

(3) American Telephone and Telegraph Company Tariff F.C.C. No. 11 services;

(4) American Telephone and Telegraph Company Tariff F.C.C. No. 12 services;

(5) American Telephone and Telegraph Company Tariff F.C.C. No. 16 services;

(6) Services subject to below-the-line accounting;

(7) International private line and record carrier services;

(8) Contract-based tariffs;

(9) Services removed from price cap regulation pursuant to the Report and Order in Docket No. 90-132;

(10) Promotional offerings for services in § 61.42 (b)(1), (b)(2) and (b)(3);

(11) All other promotional offerings;

(12) Custom tariff services; and

(13) Such other services as the Commission may specify.

(d) Each local exchange carrier subject to price cap regulation shall establish baskets of services as follows:

(1) A basket for the common line interstate access elements as described in § 69.103, 69.104, 69.105, and 69.115 of this chapter;

(2) A basket for traffic sensitive switched interstate access elements;

(3) A basket for special access services as described in § 69.114 of this chapter; and

(4) To the extent that a local exchange carrier specified in § 61.41(a) (2) or (3) offers interstate interexchange services that are not classified as access services for the purpose of part 69 of this chapter, such exchange carrier shall establish a fourth basket for such services.

(e)(1) The traffic sensitive switched interstate access basket shall contain such services as the Commission shall permit or require, including the following service categories:

(i) Local switching as described in § 69.106;

(ii) Information, as described in § 69.109; and

(iii) Transport, as described in §§ 69.111 and 69.112 of this chapter.

(2) The basked [sic] for special access services shall contain such services as the Commission shall permit or require, including the following service categories:

(i) Voice grade, WATS, metallic, and telegraph services;

(ii) Audio and video services;

(iii) High capacity and DDS services; and

(iv) Wideband data and wideband analog services.

(f) Each local exchange carrier subject to price cap regulation shall exclude from its price cap baskets such services or portions of such services as the Commission has designated or may hereafter designate by order.

(g) New services, other than those within the scope of paragraphs (c) and (f) of this section, must be included in the affected basket at the first annual price cap tariff filing following completion of the base period in which they are introduced. To the extent that such new services are permitted or required to be included in new or existing service categories within the assigned basket, they shall be so included at the first annual price cap tariff filing following completion of the base period in which they are introduced.

[54 FR 19842, May 8, 1989; as amended at 55 FR 42382, Oct. 19, 1990; 55 FR 50558, Dec. 7, 1990; 56 FR 5956, Feb. 14, 1991; 56 FR 55239, Oct. 25, 1991]

§ 61.43 Annual price cap filings required.

Carriers subject to price cap regulation shall submit annual price cap tariff filings that propose rates for the upcoming year, that make appropriate adjustments to their PCI, API, and SBI values pursuant to §§ 61.44 through 61.47, and that incorporate the costs and rates of new services into the PCI, API, or SBI calculations pursuant to §§ 61.44(g), 61.45(g), 61.46(b), and 61.47 (b) and (c). Carriers may propose rate or other tariff changes more often than annually, consistent with the requirements of § 61.59.

[54 FR 19842, May 8, 1989, as amended at 55 FR 42383, Oct. 19, 1990]

§ 61.44 Adjustments to the PCI for Dominant Interexchange Carriers.

(a) Dominant interexchange carriers subject to price cap regulation shall file adjustments to the PCI for each basket as part of the annual price cap tariff filing, and shall maintain updated PCIs to reflect the effect of mid-year access and exogenous cost changes.

(b) Subject to paragraph (d) of this section, adjustments to each PCI of dominant interexchange carriers

subject to price cap regulation shall be made pursuant to the following formula:

$$PCI_t = PCI_{t-1}[1 + w(GNP\text{-}PI - X) + \Delta Y/R + \Delta Z/R]$$

where

GNP-PI=the percentage change in the GNP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X=productivity factor of 3.0%,

ΔY=(new access rate—access rate at the time the PCI was updated to PCI_{t-1}) × (base period demand),

ΔZ=the dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

R=base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},

w=R—(access rate in effect at the time the PCI was updated to PCI_{t-1} × base period demand) + ΔZ, all divided by R,

PCI_t=the new PCI value, and

PCI_{t-1}=the immediately preceding PCI value.

(c) the exogenous cost changes represented by the term "ΔZ" in the formula detailed in paragraph (b) of this section, shall be limited to those cost changes that the Commission shall permit or require, and include those caused by:

(1) The completion of the amortization of depreciation reserve deficiencies;

(2) Changes in the Uniform System of Accounts;

(3) Changes in the Separations Manual;

(4) The reallocation of investment from regulated to nonregulated activities pursuant to § 64.901; and

(5) Such tax law changes and other extraordinary exogenous cost changes as the Commission shall permit or require.

These exogenous cost changes shall be apportioned on a cost-causative basis between price cap services as a group, and excluded services as a group. Exogenous cost changes thus attributed to price cap services shall be further apportioned on a cost-causative basis among price cap baskets.

(d) In calculating the "ΔY" variable in the formula detailed in paragraph (b) of this section:

(1) The net change in total non-traffic sensitive access costs for all capped services (in all baskets), calculated at base period demand, shall be allocated among the baskets in proportion to each basket's share of total base period non-traffic sensitive minutes of access (both originating and terminating);

(2) The net change in total traffic sensitive access costs for all capped services (in all baskets), calculated at base period demand, shall be allocated among the baskets in proportion to each basket's share of total base period traffic sensitive minutes of access; and

(3) Changes in special access costs in each basket, calculated at base period demand, shall be assigned directly to the baskets in which such costs are incurred.

(e) In calculating the "w" variable in the formula detailed in paragraph (b) of this section, the access costs that must be subtracted from the "R" variable shall be apportioned among the baskets in a manner that is consistent with the methodology provided in paragraph (d) of this section for calculating the "ΔY" in each basket.

(f) The "w(GNP-PI — X)" component of the PCI formula shall be employed only in the adjustment made in connection with the annual price cap filing.

(g) The exogenous cost changes and changes in access costs caused by new services subject to price cap regulation must be included in the appropriate PCI calculations under paragraph (b) of this section beginning at the first annual price cap tariff filing following completion of the base period in which they are introduced.

(h) In the event that a price cap tariff becomes effective, which tariff results in an API value (calculated pursuant to § 61.46) that exceeds the currently applicable PCI value, the PCI value shall be adjusted upward to equal the API value.

[54 FR 19842, May 8, 1989, as amended at 55 FR 42383, Oct. 19, 1990]

§ 61.45 Adjustments to the PCI for Local Exchange Carriers.

(a) Local exchange carriers subject to price cap regulation shall file adjustments to the PCI for each basket as part of the annual price cap tariff filing, and shall maintain updated PCIs to reflect the effect of mid-year exogenous cost changes.

(b) Adjustments to local exchange carrier PCIs for the baskets designated in §§ 61.42(d)(2), (3), and (4) shall be made pursuant to the formula set forth in § 61.44(b), and as further explained in §§ 61.44(e), (f), (g), and (h).

(1) Notwithstanding the value of X defined in § 61.44(b), the X value applicable to the baskets specified in § 61.42(d)(2) and (3) shall be 3.3%, or 4.3% if the carrier so elects.

(2) For the basket specified in § 61.42(d)(4), the value of X shall be 3%, or 4% if the carrier so elects.

(c) Subject to paragraph (e) of this section, adjustments to local exchange carrier PCIs for the basket designated in § 61.42(d)(1) shall be made pursuant to the following formula:

$PCI_t = PCI_{t-1}[1 + w[(GNP—PI—X—(g/2))/(1 + (g/2))] + \Delta Z/R]$

where

GNP—PI=The percentage change in the GNP—PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X=Productivity factor of 3.3%, or 4.3% if the carrier so elects,

g=The ratio of minutes of use per access line during the base period, to minutes of use per access line during the previous base period, minus 1,

ΔZ=The dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations.

R=Base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},

w=R + ΔZ, all divided by R,
PCI_t=The new PCI value, and
PCI_{t-1}=The immediately preceeding [sic] value.

(d) The exogenous cost changes represented by the term "ΔZ" in the formulas detailed in paragraphs (b) and (c), shall be limited to those cost changes that the Commission shall permit or require.

(1) Subject to further order of the Commission, those exogenous cost changes shall include cost changes caused by

(i) The completion of the amortization of depreciation reserve deficiencies;

(ii) Such changes in the Uniform System of Accounts as the Commission shall permit or require[;]

(iii) Changes in the Separations Manual;

(iv) Changes to the level of obligation associated with the Long Term Support Fund and the Transitional Support Fund described in § 69.612;

(v) The reallocation of investment from regulated to nonregulated activities pursuant to § 64.901;

(vi) Such tax law changes and other extraordinary exogenous cost changes as the Commission shall permit or require, and

(vii) Retargeting the PCI to the level specified by the Commission for carriers whose base year earnings are below the level of the lower adjustment mark.

(viii) Inside wire amortizations.

(2) Local exchange carriers specified in § 61.41(a)(2) or (a)(3) of this part shall also make such temporary exogenous cost changes as may be necessary to reduce PCIs to give full effect to any sharing of base period earnings required by the sharing mechanism set forth in 47 CFR parts 61, 65 and 69. Such exogenous cost changes shall include interest, computed at the prescribed rate of return, from the day after the end of the period giving rise to the adjustment, to the midpoint of the period when the adjustment is in effect.

(3) Local exchange carriers specified in § 61.41(a)(2) or (a)(3) of this part shall, in their annual access tariff filing, recognize all exogenous cost changes attributable to modifications during the coming tariff year in the obligations specified in § 61.45(d)(1)(IV) as well as those changes attributable to alterations in their Subscriber Plant Factor and the Dial Equipment Minutes factor, and completions of inside wire amortizations and reserve deficiency amortizations.

(4) Exogenous cost changes shall be apportioned on a cost-causative basis between price cap services as a group, and excluded services as a group. Exogenous cost

changes thus attributed to price cap services shall be further apportioned on a cost-causative basis among the price cap baskets.

(e) The "w[(GNP-PI-X-(g/2))/(1+(g/2))]" component of the PCI formula contained in paragraph (c) shall be employed only in the adjustment made in connection with the annual price cap filing.

(f) The exogenous costs caused by new services subject to price cap regulation must be included in the appropriate PCI calculations under paragraph (c) of this section beginning at the first annual price cap tariff filing following completion of the base period in which such services are introduced.

(g) In the event that a price cap tariff becomes effective, which tariff results in an API value (calculated pursuant to § 61.46) that exceeds the currently applicable PCI value, the PCI value shall be adjusted upward to equal the API value.

(h) To the extent a local exchange carrier elects the higher productivity factor, the election must be made in all baskets.

[55 FR 42383, Oct. 19, 1990; 55 FR 50558, Dec. 7, 1990, as amended at 56 FR 21617, May 10, 1991]

§ 61.46 Adjustments to the API.

(a) Except as provided in paragraphs (d) and (e) of this section, in connection with any price cap tariff filing proposing rate changes, the carrier must calculate an API for each affected basket pursuant to the following methodology:

$$API_t = API_{t-1} [\Sigma_i \, v_i \, (P_t/P_{t-1})_i]$$

where
API_t = the proposed API value,
API_{t-1} = the existing API value,
P_t = the proposed price for rate element "i,"
P_{t-1} = the existing price for rate element "i," and

v_i = the current estimated revenue weight for rate element "i," calculated as the ratio of the base period demand for the rate element "i" priced at the existing rate, to the base period demand for the entire basket of services priced at existing rates.

(b) New services subject to price cap regulation must be included in the appropriate API calculations under paragraph (a) of this section beginning at the first annual price cap tariff filing following completion of the base period in which they are introduced. This index adjustment requires that the demand for the new service during the base period must be included in determining the weights used in calculating the API.

(c) Any price cap tariff filing proposing rate restructuring shall require an adjustment to the API pursuant to the general methodology described in paragraph (a) of this section. This adjustment requires the conversion of existing rates into rates of equivalent value under the proposed structure, and then the comparison of the existing rates that have been converted to reflect restructuring to the proposed restructured rates. This calculation may require use of carrier data and estimation techniques to assign customers of the preexisting service to those services (including the new restructured service) that will remain or become available after restructuring.

(d) In connection with any price cap tariff proposing changes to rates for services in the basket designated in § 61.42(d)(1), the maximum allowable carrier common

line (CCL) charges shall be computed pursuant to the following methodology:

$$CCL_{mou} = CL_{mou}^{*} \ (1 + \% \text{ change in CL PCI}) - EUCL_{mou}^{*} \ 1/(1 + (g/2))$$

where

CCL_{mou} = The sum of each of the proposed Carrier Common Line rates multiplied by its corresponding base period Carrier Common Line minutes of use, divided by the sum of all types of base period Carrier Common Line minutes of use,

CL_{mou} = The sum of each of the existing maximum allowable Carrier Common Line rates multiplied by its corresponding base period Carrier Common Line minutes of use plus each existing End User Common Line (EUCL) rate multiplied by its corresponding base period lines, divided by the sum of all types of base period Carrier Common Line minues of use,

$EUCL_{mou}$ = Proposed End User Line rates multiplied by base period lines and divided by the sum of all types of base period Carrier Common Line minutes of use, and

g = The ratio of minutes of use per access line during the base period to minutes of use per access line during the previous base period, minus 1.

(e) In addition, for the purposes of § 61.46(d), "Existing Carrier Common Line Rates" shall include existing originating premium, originating non-premium, terminating premium, and terminating non-premium rates; and "End User Common Line Rates" used to calculate the CI_{mou} and the $EUCL_{mou}$ factors shall include, but not be limited to, Residential and Single Line Business rates, Multi-Line Business rates, Centrex rates, Limited Pay Telephone Rates, and the Special Access surcharge.

(f) The "1/(1+(g/2)[)]" component of the CCL_{mou} formula contained in paragraph (d) shall be employed only in the adjustment made in connection with the annual price cap filing.

[54 FR 19843, May 8, 1989, as amended at 55 FR 42383, Oct. 19, 1990; 55 FR 50558, Dec. 7, 1990]

§ 61.47 Adjustments to the SBI; pricing bands.

(a) In connection with any price cap tariff filing proposing changes in the rates of service categories, the carrier must calculate an SBI value for each affected service category pursuant to the following methodology:

$$SBI_t = SBI_{t-1}[\Sigma_i V_i(P_t/P_{t-1})_i]$$

where
SBI_t = the proposed SBI value,
SBI_{t-1} = the existing SBI value,
P_t = the proposed price for rate element "i,"
P_{t-1} = the existing price for rate element "i," and
v_i = the current estimated revenue weight for rate element "i," calculated as the ratio for the base period demand for the rate element "i" priced at the existing rate, to the base period demand for the entire group of rate elements comprising the service category priced at existing rates.

(b) New services that are added to existing service categories must be included in the appropriate SBI calculations under paragraph (a) of this section beginning at the first annual price cap tariff filing following completion of the base period in which they are introduced. This index adjustment requires that the demand for the new service during the base period must be included in determining the weights used in calculating the SBI.

(c) In the event that the introduction of a new service requires the creation of a new service category, a new SBI must be established for that service category begin-

ning at the first annual price cap tariff filing following completion of the base period in which the new service is introduced. The new SBI should be initialized at a value of 100, corresponding to the service category rates in effect the last day of the base period, and thereafter should be adjusted as provided in paragraph (a) of this section.

(d) Any price cap tariff filing proposing rate restructuring shall require an adjustment to the affected SBI pursuant to the general methodology described in paragraph (a) of this section. This adjustment requires the conversion of existing rates in the rate element group into rates of equivalent value under the proposed structure, and then the comparison of the existing rates that have been converted to reflect restructuring to the proposed restructured rates. This calculation may require use of carrier data and estimation techniques to assign customers of the preexisting service to those services (including the new restructured service) that will remain or become available after restructuring.

(e) Pricing bands shall be established each tariff year for each service category within a basket. Except as provided in paragraph (f) of this section, each band shall limit the pricing flexibility of the service category, as reflected in its SBI, to an annual increase or decrease of five percent, relative to the percentage change in the PCI for that basket, measured from the levels in effect on the last day of the preceding tariff year.

(f) The upper pricing bands for the evening MTS and night/weekend MTS service categories shall limit the annual upward pricing flexibility for those service categories, as reflected in their SBIs, to four percent, relative to the percentage change in the PCI for the residential and small business services basket, measured from the last day of the preceding tariff year.

(g) Dominant interexchange carriers subject to price cap regulation shall calculate a composite average rate

for services contained in the residential and small business services basket that are purchased by residential customers. Notwithstanding paragraphs (e) and (f) of this section, the annual upward pricing flexibility for this composite average rate shall be limited to one percent, relative to the percentage change in the PCI for the residential and small business services basket, measured from the last day of the preceding tariff year.

(h) Local exchange carriers subject to price cap regulation as that term is defined in § 61.3(w) of this chapter shall use the methodology set forth in paragraphs (a) through (d) of this section to calculate two separate subindexes: One for the DS1 services offered by such carriers and the other for the DS3 services offered by such carriers. Notwithstanding paragraph (e) of this section, the annual pricing flexibility for each of these two subindexes shall be limited to an annual increase or decrease of five percent, relative to the percentage change in the PCI for the special access services basket, measured from the last day of the preceding tariff year.

[54 FR 19843, May 8, 1989, as amended at 55 FR 42384, Oct. 19, 1990; 56 FR 55239, Oct. 25, 1991]

§ 61.48 Transition rules for price cap formula calculations.

(a) Dominant interexchange carriers subject to price cap regulation shall file initial price cap tariffs May 17, 1989, to be effective July 1, 1989.

(b)(1) In connection with the initial price cap tariff filing described in paragraph (a) of this section, each PCI, API, and SBI shall be assigned an initial value prior to adjustment of 100, corresponding to the costs and rates in effect as of December 31, 1988.

(2) The PCI and API for offerings under § 61.42 (b)(3) shall be assigned a value equal to 100, corresponding to rates in effect as of August 1, 1991. Domi-

nant interexchange carriers subject to price cap regulation shall file new business basket index levels with the first business basket tariff transmittal that is filed subsequent to the effective date of this rule.

(c) Local exchange carriers subject to price cap regulation shall file initial price cap tariffs not later than November 1, 1990, to be effective January 1, 1991.

(d)(1) In connection with the initial price cap filing described in paragraph (c) of this section, each PCI, API, and SBI shall be assigned an initial value prior to adjustment of 100, corresponding to the costs and rates in effect as of July 1, 1990.

(2) Carriers electing price cap regulation under § 61.41 (a)(3) of this part in a year after 1991 shall file initial price cap tariffs not later than April 2 of the year of election, to be effective on July 1 of the year of election. Each PCI, API, and SBI shall be assigned an initial value prior to adjustment of 100, corresponding to the costs and rates in effect as of January 1 of the year of election.

(e) In connection with the initial price cap filing described in paragraph (c) of this section, initial PCI calculations shall be made without adjustment for any changes in inflation or productivity. Annual price cap filings incorporating the full values of the GNP-PI and productivity offsets will commence April 2, 1991, with a scheduled effective date of July 1, 1991.

(f) Local exchange carriers specified in § 61.41(a) (2) or (3) shall, in their initial price cap filings described in paragraph (c) of this section, adjust their PCIs through use of an exogenous cost factor to account for the represcription of the rate of return, effective January 1, 1991.

[54 FR 19843, May 8, 1989, as amended at 55 FR 42384, Oct. 19, 1990; 56 FR 21617, May 10, 1991; 56 FR 55239, Oct. 25, 1991]

§ 61.49 Supporting information to be submitted with letters of transmittal for tariffs of carriers subject to price cap regulation.

(a) Each price cap tariff filing must be accompanied by supporting materials sufficient to calculate required adjustments to each PCI, API, and SBI pursuant to the methodologies provided in §§ 61.44, 61.45, 61.46, and 61.47, as applicable[.]

(b) Each price cap tariff filing that proposes rates that are within applicable bands established pursuant to § 61.47, and that results in an API value that is equal to or less than the applicable PCI value, must be accompanied by supporting materials sufficient to establish compliance with the applicable bands, and to calculate the necessary adjustment to the affected APIs and SBIs pursuant to §§ 61.46 and 61.47, respectively.

(c) Each price cap tariff filing that proposes rates above the applicable band limits established in §§ 61.47(e) and (f), or above the limit on composite average residential rates established in § 61.47(g), must be accompanied by supporting materials establishing substantial cause for the proposed rates.

(d) Each price cap filing that proposes service category rates below applicable band limits established in § 61.47(e) of this part, must be accompanied by supporting materials establishing that the rates cover the service category's average variable cost, or equivalently, that the service category's net additional revenue resulting from the price change exceeds additional costs.

(e) Each price cap tariff filing that proposes rates that will result in an API value that exceeds the applicable PCI value must be accompanied by: (1) An explanation of the manner in which all costs have been allocated among baskets; and (2) within the affected basket, a cost assignment slowing down to the lowest possible level of disaggregation, including a detailed explanation of the rea-

sons for the prices of all rate elements to which costs are not assigned.

(f) Each price cap tariff filing that proposes restructuring of existing rates must be accompanied by supporting materials sufficient to make the adjustments to each affected API and SBI required by §§ 61.46(c) and 61.47(d), respectively.

(g)(1) Each tariff filing by a dominant interexchange carrier, as specified by Commission order, that introduces a new service that will later be included in a basket must be accompanied by cost data sufficient to establish that the new service, and each unbundled element thereof, will generate a net revenue increase—measured against revenues generated from all services subject to price cap regulation, and calculated based upon present value—within the lesser of a 24-month period after an annual price cap tariff including the new service takes effect, or 36 months from the date the new service becomes effective. Each carrier making such a tariff filing must, at the time the new service is incorporated into the price cap index, submit data sufficient to make the API and PCI calculations required by §§ 61.46(b) and 61.44(c) of this part, and, as necessary, to make the SBI calculations provided in § 61.47(b) or (c) of this part.

(2) In addition to the requirements of § 61.49(g)(1), each tariff filing submitted by a local exchange carrier specified in § 61.41(a)(2) or (3) of this part that introduces a new service that will later be included in a basket must be accompanied by cost data sufficient to establish that the new service will not recover more than a just and reasonable portion of the carrier's overhead costs.

(h) Each tariff filing by a local exchange carrier that introduces a new service that will later be included in a basket must also be accompanied by

(1) The following, including complete explanations of the bases for the estimates.

(i) a study containing a projection of costs for a representative 12 month period; and

(ii) Estimates of the effect of the new tariff on the traffic and revenues from the service to which the new tariff applies, the carrier's other service classifications, and the carrier's overall traffic and revenues. These estimates must include the projected effects on the traffic and revenues for the same representative 12 month period used in paragraph (h)(1)(i) of this section.

(2) Working papers and statistical data.

(i) Concurrently with the filing of any tariff change or tariff filing for a service not previously offered, the Chief, Tariff Review Branch must be provided two sets of working papers containing the information underlying the data supplied in response to paragraph (h)(1) of this section, and a clear explanation of how the working papers relate to that information.

(ii) All statistical studies must be submitted and supported in the form prescribed in § 1.363 of the Commission's rules.

[54 FR 19843, May 8, 1989, as amended at 55 FR 42384, Oct. 19, 1990; 56 FR 5956, Feb. 14, 1991; 56 FR 21617, May 10, 1991; 56 FR 33880, July 24, 1991; 57 FR 37730, Aug. 20, 1992]

47 C.F.R. § 69.3 (1992)

§ 69.3 Filing of access service tariffs.

(a) Except as provided in paragraphs (f) and (g) of this section, a tariff for access service shall be filed with this Commission for an annual period. Such tariffs shall be filed on a minimum of 90 days' notice with a scheduled effective date of July 1. Such tariff filings shall be limited to rate level changes.

(b) The requirements imposed by paragraph (a) of this section shall not preclude the filing of revisions to those annual tariffs that will become effective on dates other than July 1.

(c) Any access service tariff filing, the filing of any petitions for rejection, investigation or suspension and the filing of any responses to such petitions shall comply with the applicable rules of this Commission relating to tariff filings.

(d) The association shall file a tariff as agent for all telephone companies that participate in an association tariff.

(e) A telephone company or group of telephone companies may file a tariff that is not an association tariff. Such a tariff may cross-reference the association tariff for some access elements and include separately computed charges of such company or companies for other elements. Any such tariff must comply with the requirements hereinafter provided:

(1) Such a tariff must cross reference association charges for the Carrier Common Line and End User Common Line element or elements if such company or companies participate in the pooling of revenues and revenue requirements for such elements.

(2) Such a tariff that cross-references an association charge for any end user access element must cross-reference association charges for all end user access elements;

(3) Such a tariff that cross-references an association charge for any carrier's carrier access element other than the Carrier Common Line element must cross-reference association charges for all carrier's carrier access charges other than the Carrier Common Line element;

(4) Except for charges subject to price cap regulation as that term is defined in § 61.3(v) of this chapter, any charge in such a tariff that is not an association charge

must be computed to reflect the combined investment and expenses of all companies that participate in such a charge;

(5) A telephone company or companies that elect to file such a tariff for 1984 access charges shall notify AT&T on or before the 40th day after the release of the Commission order adopting this part;

(6) A telephone company or companies that elect to file such a tariff shall notify the association not later than December 31 of the preceding year, if such company or companies did not file such a tariff in the preceding annual period or cross-reference association charges in such preceding period that will not be cross-referenced in the new tariff.

(7) Such a tariff shall not contain charges for any access elements that are disaggregated or deaveraged within a study area that is used for purposes of jurisdictional separations.

(8) Such a tariff shall not contain charges included in the billing and collection category.

(9) A telephone company or group of affiliated telephone companies that elects to file its own Carrier Common Line tariff effective April 1, 1989 shall notify the association not later than August 30 of the preceding year that it will no longer participate in the association tariff. A telephone company or group of affiliated telephone companies that elects to file its own Carrier Common Line tariff effective July 1, 1990 or thereafter pursuant to § 69.3(a) shall notify the association not later than December 31 of the preceding year that it will no longer participate in the association tariff. A telephone company or group of affiliated telephone companies that electes [sic] to file its own Carrier Common Line tariff for one of its study areas shall file its own Carrier Common Line tariff(s) for all of its study areas.

(10) Any data supporting a tariff that is not an association tariff shall be consistent with any data that the filing carrier submitted to the association.

(11) Any changes in Association common line tariff participation and Long Term and Transitional Support resulting from the merger or acquisition of telephone properties are to be made effective on the next annual access tariff filing effective date following consummation of the merger or acquisition transaction, in accordance with the provisions of § 69.3(e)(9).

(f) A tariff for access service provided by a telephone company that may file an access tariff pursuant to § 61.39 may be filed for a biennial period with a minimum of 90 days notice and scheduled effective date of July 1 of any odd numbered year. An eligible telephone company that does not elect to file an access tariff pursuant to the § 61.39 procedures may elect to file a biennial tariff pursuant to this section. For purposes of computing charges for access elements other than Common Line elements to be effective on July 1 of any even-numbered year, the association may compute rate changes based upon statistical methods which represent a reasonable equivalent to the cost support information otherwise required under part 61 of this chapter.

(g) The following rules apply to telephone company participation in the Association common line pool for telephone companies involved in a merger or acquisition.

(1) Notwithstanding the requirements of § 69.3(e)(9), any Association common line tariff participant that is party to a merger or acquisition may continue to participate in the Association common line tariff.

(2) Notwithstanding the requirements of § 69.3(e)(9), any Association common line tariff participant that is party to a merger or acquisition may include other telephone properties involved in the transaction in the Association common line tariff, provided that the net

addition of common lines to the Association common line tariff resulting from the transaction in [sic] not greater than 50,000, and provided further that, if any common lines involved in a merger or acquisition are returned to the Association common line tariff, all of the common lines involved in the merger or acquisition must be returned to the Association common line tariff.

(3) Telephone companies involved in mergers or acquisitions that wish to have more than 50,000 common lines reenter the Association common line pool must request a waiver of § 69.3(e)(9). If the telephone company has met all other legal obligations, the waiver request will be deemed granted on the sixty-first (61st) day from the date of public notice inviting comment on the requested waiver unless:

(i) The merger or acquisition involves one or more partial study areas;

(ii) The waiver includes a request for confidentiality of some or all of the materials supporting the request;

(iii) The waiver includes a request to return only a portion of the telephone properties involved in the transaction to the Association common line tariff;

(iv) The Commission rejects the waiver request prior to the expiration of the sixty-day period;

(v) The Commission requests additional time or information to process the waiver application prior to the expiration of the sixty-day period; or

(vi) A party, in a timely manner, opposes a waiver request or seeks conditional approval of the waiver in response to our public notice of the waiver request.

(h) Local exchange carriers subject to price cap regulation as that term is defined in § 61.3(v) of this chapter, shall file with this Commission a price cap tariff for access service for an annual period. Subject to § 61.48, such tariffs shall be filed to provide a minimum of 90

days' notice with a scheduled effective date of July 1. Such tariff filings shall be limited to changes in the Price Cap Indexes, rate level changes (with corresponding adjustments to the affected Actual Price Indexes and Service Band Indexes), and the incorporation of new services into the affected indexes as required by § 61.49 of this chapter.

(i) The following rules apply to the withdrawal from Association tariffs under the provisions of paragraphs (e)(6) or (e)(9) of this section or both by telephone companies electing to file price cap tariffs pursuant to § 69.3(h).

(1) In addition to the withdrawal provisions of § 69.3(e) (6) and (9), a telephone company that participates in one or more Association tariffs during one tariff year and that elects to file price cap tariffs effective July 1 of the following tariff year, shall provide the Association with at least 6 months' notice that it is withdrawing from all Association tariffs, subject to the terms of this Rule, to participate in price cap regulation.

(2) The Association shall maintain records of such withdrawals sufficient to discharge its obligations under these Rules and to detect efforts by such companies or their affiliates to rejoin any Association tariffs in violation of the provisions of paragraph (i)(4) of this section.

(3) Notwithstanding the provisions of § 69.3(e)(6) and (9), in the event a telephone company withdraws from all Association tariffs for the purpose of filing price cap tariffs, such company shall exclude from such withdrawal all "average schedule" affiliates and all affiliates so excluded shall be specified in the withdrawal. However, such company may include one or more "average schedule" affiliates in price cap regulation provided that each price cap affiliate relinquishes "average schedule" status and withdraws from all Association tariffs and any tariff filed pursuant to § 61.39(b)(2). *See generally* §§ 69.605 (c), 61.39(b) of this chapter; MTS and WATS Market

Structure: Average Schedule Companies, Report and Order, 103 FCC 2D 1026-1027 (1986).[1]

(4) If a telephone company elects to withdraw from Association tariffs and thereafter becomes subject to price cap regulation as that term is defined in § 61.3(v) of this chapter, neither such telephone company nor any of its withdrawing affiliates shall thereafter be permitted to participate in any Association tariffs.

(47 U.S.C. 154(i) and (j), 201, 202, 203, 205, 218 and 403 and 5 U.S.C. 553)

[48 FR 10358, Mar. 11, 1983, as amended at 48 FR 43017, Sept. 21, 1983; 50 FR 41356, Oct. 10, 1985; 51 FR 6119, Feb. 20, 1986; 51 FR 42236, Nov. 24, 1986; 52 FR 21540, June 8, 1987; 52 FR 37310, Oct. 6, 1987; 53 FR 36289, Sept. 19, 1988; 54 FR 39534, Sept. 27, 1989; 55 FR 6990, Feb. 28, 1990; 55 FR 42385, Oct. 19, 1990; 55 FR 50558, Dec. 7, 1990]

47 C.F.R. § 69.3 (1990)

§ 69.3 Filing of access service tariffs

(a) Except as provided in § 69.3 of this chapter, a tariff for access service shall be filed with this Commission for an annual period. Such tariffs shall be filed so as to provide a minimum of 90 days notice with a scheduled effective date of July 1. Such tariff filings shall be limited to rate level changes.

(b) The requirements imposed by paragraph (a) of this section shall not preclude the filing of revisions to those annual tariffs that will become effective on dates other than July 1.

(c) Any access service tariff filing, the filing of any petitions for rejection, investigation or suspension and the filing of any responses to such petitions shall comply

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[1] The FCC 2d is available in the Publications Branch, room 224, Federal Communications Commission, 1919 M St., NW., DC 20554.

with the applicable rules of this Commission relating to tariff filings.

(d) The association shall file a tariff as agent for all telephone companies that participate in an association tariff.

(e) A telephone company or group of telephone companies may file a tariff that is not an association tariff. Such a tariff may cross-reference the association tariff for some access elements and include separately computed charges of such company or companies for other elements. Any such tariff must comply with the requirements hereinafter provided:

(1) Such a tariff must cross reference association charges for the Carrier Common Line and End User Common Line element or elements if such company or companies participate in the pooling of revenues and revenue requirements for such elements.

(2) Such a tariff that cross-references an association charge for any end user access element must cross-reference association charges for all end user access elements;

(3) Such a tariff that cross-references an association charge for any carrier's carrier access element other than the Carrier Common Line element must cross-reference association charges for all carrier's carrier access charges other than the Carrier Common Line element;

(4) Any charge in such a tariff that is not an association charge must be computed to reflect the combined investment and expenses of all companies that participate in such a charge;

(5) A telephone company or companies that elect to file such a tariff for 1984 access charges shall notify AT&T on or before the 40th day after the release of the Commission order adopting this part;

(6) A telephone company or companies that elect to file such a tariff shall notify the association not later than

December 31 of the preceding year, if such company or companies did not file such a tariff in the preceding annual period or cross-reference association charges in such preceding period that will not be cross-referenced in the new tariff.

(7) Such a tariff shall not contain charges for any access elements that are disaggregated or deaveraged within a study area that is used for purposes of jurisdictional separations.

(8) Such a tariff shall not contain charges included in the billing and collection category.

(9) A telephone company or group of affiliated telephone companies that elects to file it own Carrier Common Line tariff effective April 1, 1989 shall notify the association not later than August 30 of the preceding year that it will no longer participate in the association tariff. A telephone company or group of affiliated telephone companies that elects to file its own Carrier Common Line tariff effective July 1, 1990 or thereafter pursuant to § 69.3(a) shall notify the association not later than December 31 of the preceding year that it will no longer participate in the association tariff. A telephone company or group of affiliated telephone companies that electes [sic] to file its own Carrier Common Line tariff for one [of] its study areas shall file its own Carrier Common Line tariff(s) for all of its study areas.

(10) Any data supporting a tariff that is not an association tariff shall be consistent with any data that the filing carrier submitted to the association.

(11) Any changes in Association common line tariff participation and Long Term and Transitional Support resulting from the merger or acquisition of telephone properties are to be made effective on the next annual access tariff filing effective date following consummation of the merger or acquisition transaction, in accordance with the provisions of § 69.3(e)(9).

(f) A tariff for access service provided by a telephone company that may file an access tariff pursuant to § 61.39 may be filed for a biennial period with a minimum of 90 days notice and scheduled effective date of July 1 of any odd numbered year. An eligible telephone company that does not elect to file an access tariff pursuant to the § 61.39 procedures may elect to file a biennial tariff pursuant to this section. For purposes of computing charges for access elements other than Common Line elements to be effective on July 1 of any even-numbered year, the association may compute rate changes based upon statistical methods which represent a reasonable equivalent to the cost support information otherwise required under Part 61 of this chapter.

(g) The following rules apply to telephone company participation in the Association common line pool for telephone companies involved in a merger or acquisition.

(1) Notwithstanding the requirements of § 69.3(e)(9), any Association common line tariff participant that is party to a merger or acquisition may continue to participate in the Association common line tariff.

(2) Notwithstanding the requirements of § 69.3(e)(9), any Association common line tariff participant that is party to a merger or acquisition may include other telephone properties involved in the transaction in the Association common line tariff, provided that the net addition of common lines to the Association common line tariff resulting from the transaction in [sic] not greater than 50,000, and provided further that, if any common lines involved in a merger or acquisition are returned to the Association common line tariff, all of the common lines involved in the merger or acquisition must be returned to the Association common line tariff.

(3) Telephone companies involved in mergers or acquisitions that wish to have more than 50,000 common lines reenter the Association common line pool must request a

waiver of § 69.3(e)(9). If the telephone company has met all other legal obligations, the waiver request will be deemed granted on the sixty-first (61st) day from the date of public notice inviting comment on the requested waiver unless:

(i) The merger or acquisition involves one or more partial study areas;

(ii) The waiver includes a request for confidentiality of some or all of the materials supporting the request;

(iii) The waiver includes a request to return only a portion of the telephone properties involved in the transaction to the Association common line tariff;

(iv) The Commission rejects the waiver request prior to the expiration of the sixty-day period;

(v) The Commission requests additional time or information to process the waiver application prior to the expiration of the sixty-day period; or

(vi) A party, in a timely manner, opposes a waiver request or seeks conditional approval of the waiver in response to our public notice of the waiver request.

(47 U.S.C. 154(i) and (j), 201, 202, 203, 205, 218 and 403 and 5 U.S.C. 553)

[48 FR 10358, Mar. 11, 1983, as amended at 48 FR 43017, Sept. 21, 1983; 50 FR 41356, Oct. 10, 1985; 51 FR 6119, Feb. 20, 1986; 51 FR 42236, Nov. 24, 1986; 52 FR 21540, June 8, 1987; 52 FR 37310, Oct. 6, 1987; 53 FR 36289, Sept. 19, 1988; 54 FR 39534, Sept. 27, 1989; 55 FR 6990, Feb. 28, 1990]

Supreme Court, U.S.
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No. 93-1463

In the Supreme Court of the United States

OCTOBER TERM, 1993

SOUTHWESTERN BELL TELEPHONE COMPANY,
PETITIONER

v.

FEDERAL COMMUNICATIONS COMMISSION
AND UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

DREW S. DAYS, III
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

WILLIAM E. KENNARD
General Counsel

JOHN E. INGLE
Deputy Associate General Counsel

JAMES M. CARR
Counsel
Federal Communications Commission
Washington, D.C. 20554

QUESTION PRESENTED

Whether petitioner had adequate notice of the standards that the Federal Communications Commission would apply to petitioner's proposed tariff filing.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-17a) is reported at 10 F.3d 892. The order of the Federal Communications Commission on remand (Pet. App. 18a-30a) is reported at 8 F.C.C. Rcd. 2261. The Commission's initial memorandum opinion and order (Pet. App. 33a-69a) is reported at 7 F.C.C. Rcd. 2906. The order of the Commission's Common Carrier Bureau (Pet. App. 71a-81a) is reported at 6 F.C.C. Rcd. 2089.

JURISDICTION

The judgment of the court of appeals was entered on December 17, 1993. Pet. App. 1a. The petition for a writ of certiorari was filed on March 17, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Until recently, the Federal Communications Commission (FCC or Commission) regulated interstate telephone access rates under a rate-of-return system. Under that system, telephone companies recovered their costs plus a designated rate of return on their investment. Because the system permitted companies to set rates that were designed to recover their costs plus a designated return on investment, it gave companies no incentive to operate efficiently. See *Policy and Rules Concerning Rates for Dominant Carriers*, 3 F.C.C. Rcd. 3195, 3218-3219 (¶ 38), 3222 (¶ 43) (1988).

On October 4, 1990, the Commission announced its decision to replace the rate-of-return system with a "price cap" system for the access rates of the largest local exchange carriers (LECs), of which petitioner is one. *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C. Rcd. 6786 (1990) (*LEC Price Cap Order*), recon. denied, 6 F.C.C. Rcd. 2637, further recon. dismissed, 6 F.C.C. Rcd. 7482 (1991), aff'd *sub nom. National Rural Telecom Ass'n* v. *FCC*, 988 F.2d 174 (D.C. Cir. 1993). In the order announcing that decision, the *LEC Price Cap Order*, the Commission explained that the price cap system would give LECs an incentive to operate efficiently. Under the new system, the Commission would accord a presumption of lawfulness to interstate access rates that fell at or below a price cap and within specified pricing bands for groups of services known as "baskets." *LEC Price Cap Order*, 5 F.C.C.

Rcd. at 6788 (¶¶ 11-12). The new system would allow an efficient LEC "to retain reasonably higher earnings than would be available under the former [rate-of-return] system." *Id.* at 6787 (¶ 2).

The Commission stated in the *LEC Price Cap Order* that the price cap system would take effect on October 31, 1990. The Commission also ordered the LECs to file their first price cap tariffs by November 1, 1990, with an effective date of January 1, 1991. *LEC Price Cap Order*, 5 F.C.C. Rcd. at 6837 (¶ 413). Further, the Commission determined that initial price caps would be fixed by reference to the LECs' access rates as of July 1, 1990. The Commission explained that it chose a "historical date, as opposed to a prospective one," to prevent LECs "from engaging in * * * price increases in the period leading up to price caps." *Id.* at 6814 (¶ 231).

The new price cap system would induce greater productivity only if the LECs could not easily circumvent or increase their price caps. For that reason, the Commission limited the means by which LECs could obtain upward adjustments of their caps. First, an LEC could adjust its cap upward if it proved that its annual profit level had fallen below 10.25%, the most recent rate of return the FCC had prescribed. *LEC Price Cap Order*, 5 F.C.C. Rcd. at 6788 (¶ 10), 6806-6807 (¶¶ 164, 165); 47 C.F.R. 61.45(d)(1) (vii). Second, an LEC could increase its cap by proving that it had incurred certain kinds of exogenous costs—*i.e.*, certain costs over which it had no control. *LEC Price Cap Order*, 5 F.C.C. Rcd. at 6807-6810 (¶¶ 166-190); 47 C.F.R. 61.45(d)(1). Third, an LEC could increase its cap if it alleged that the price cap rules would not permit it to attract sufficient capital or continue to operate, and if it supported that allegation by cost support data broken down by baskets and a detailed explanation of cost allocation among

services within each basket. *LEC Price Cap Order*, 5 F.C.C. Rcd. at 6823-6824 (¶¶ 300-304); 47 C.F.R. 61.49(e).

2. In accordance with the *LEC Price Cap Order*, petitioner filed its initial price cap tariff on November 1, 1990. The rates in that tariff fell within the cap established by petitioner's July 1990 access rates. Later in November 1990, however, petitioner advised the FCC of its intention to file a proposal to increase its July 1990 rates. In connection with the proposed tariff filing, petitioner requested, and the FCC's Common Carrier Bureau granted, a waiver of 47 C.F.R. 61.38(b)(1), which requires the filing of certain data to support a proposed tariff change, and 47 C.F.R. 61.59, which provides that a new rate may not be changed until it has been in effect for at least 30 days. The Bureau denied, however, petitioner's request for a waiver of 47 C.F.R. 61.58, which prescribes a 45-day notice period before a proposed tariff may become effective. Pet. App. 6a-7a, 50a.

Petitioner filed its proposed tariff revision, Transmittal No. 2051, on December 4, 1990. Petitioner later filed a request (Application No. 257) to submit additional data to justify an even larger rate increase than proposed in Transmittal No. 2051. Under the 45-day notice requirement of Section 61.58, petitioner's proposed rate increase could not take effect until January 18, 1991—more than two weeks after the effective date of petitioner's first price cap tariff. Thus, petitioner's filing, if accepted, would not increase rates for any part of the six-month period between July 1 and December 31, 1990. Its only effect would be to raise petitioner's price cap, and hence the rates that petitioner could charge after January 1, 1991, under the price cap system. Pet. App. 19a, 23a, 33a. Nonetheless, petitioner did not purport to justify its filing under any of the three methods prescribed in the price cap rules for obtaining

an upward cap adjustment. Instead, petitioner merely claimed that its July 1990 rates were too low in light of costs incurred after July 1990.

In April 1991, the Bureau rejected petitioner's proposed tariff filing. The Bureau concluded that "[petitioner's] adjustments to its initial price cap rates and indexes are not allowed by the Commission's price cap regulations and violate the *LEC Price Cap Order*." Pet. App. 71a, 78a. The Bureau reasoned that the *LEC Price Cap Order* did not contemplate adjustments of price caps "to fine tune rates to the authorized [rate-of-return] level," because permitting such adjustments "would have created the kind of incentives the Commission sought to avoid"—incentives for LECs to manipulate their rates on the eve of price cap regulation. *Id.* at 79a. The Bureau also observed that petitioner's post-July 1990 costs did not reflect extraordinary exogenous costs warranting an upward cap adjustment under the price cap rules. *Id.* at 79a-80a. Finally, the Bureau indicated that it would have rejected petitioner's filing even if the rate-of-return system were still in effect, because petitioner had not submitted sufficient data to support its proposed rate increase. *Id.* at 80a; see also *id.* at 70a (dismissing Application No. 257 as moot).

3. The Commission affirmed the Bureau's rejection of petitioner's proposed tariff filing. Pet. App. 33a-34a The Commission, like the Bureau, emphasized that permitting rate increases on the eve of price cap regulation could undermine the incentives provided by the price cap system. To avoid that result, the Commission held that petitioner's proposed rate increase had to satisfy "more stringent criteria than those traditionally prevailing under rate of return." *Id.* at 40a-41a (¶¶ 16-17), 43a (¶ 19). The Commission determined that petitioner's proposal did not meet those criteria. *Id.*

at 44a-47a (¶¶ 21-23). In addition, the Commission observed that "[petitioner's] tariff revisions were not scheduled to become effective until after the changeover to price cap regulation," and that, as the Bureau had concluded, petitioner's application did not satisfy the criteria established under the price cap rules for obtaining an upward cap adjustment. *Id.* at 49a-52a (¶¶ 29-32).

The Commission made a technical adjustment in petitioner's July 1990 rates based on the exclusion of anomalous data from 1986. That adjustment increased petitioner's permissible revenues under the price cap by $6.87 million. Pet. App. 47a-48a (¶¶ 25-26).[1]

4. Petitioner sought review of the Commission's order in the court of appeals. On the Commission's motion, the court remanded the case to the Commission. Pet. App. 8a.

On remand, the Commission reaffirmed its prior decision and clarified the basis for that decision. Pet. App. 19a (¶ 2). The Commission explained that the primary basis for its prior decision was that the Bureau had "correctly rejected" petitioner's proposed tariff filing "as patently unlawful for failing to comply with applicable price cap requirements." *Id.* at 21a (¶ 6); see also *id.* at 25a-26a (¶ 12) ("We reaffirm our earlier conclusion that the Bureau properly applied price cap rather than rate of return regulation to Transmittal 2051."). The Commission determined that because petitioner's proposed tariff filing was "filed after the

---

[1] Commissioner Barrett concurred in the technical adjustment but dissented from the rest of the Commission's decision on the basis of his view that "the *LEC Price Cap Order* was not explicit on how mid-course corrections would be treated on the eve of price caps." Pet. App. 67a.

price cap rules became law on October 31, 1990, and b[ore] an effective date later than December 31, 1990, [it] necessarily was subject to the price cap rules rather than rate of return regulation." *Id.* at 22a n.9. The Commission rejected petitioner's claim that it lacked adequate notice that its filing would be subject to the price cap rules rather than rate-of-return criteria. *Id.* at 25a (¶ 11). The Commission also reaffirmed its prior determination that rejection of petitioner's filing would have been required even under rate-of-return criteria. *Id.* at 28a (¶ 16).[2]

6. The court of appeals denied petitioner's petition for review of the Commission's order on remand. Pet. App. 1a-17a. The court began by observing that petitioner did not dispute that it had not justified an increase in its price cap under the price cap rules. *Id.* at 9a n.3. The court identified the "principal issue" raised by petitioner as "whether the FCC provided [petitioner] sufficient notice in the price cap order" that the price cap rules—or, at least, more stringent criteria than obtained under the former rate-of-return system—would apply to proposed rate increases that were to take effect after the effective date of the price cap system established in the *LEC Price Cap Order—i.e.*, January 1, 1991. *Id.* at 9a.

"After careful review," the court found "ample support for the proposition that the price cap rules set forth the exclusive mechanisms for raising price caps to account for actual costs after January 1, 1991." Pet. App. 10a.[3]

---

[2] Commissioner Barrett again dissented. Pet. App. 29a-30a.

[3] Because the court held that the *LEC Price Cap Order* gave petitioner adequate notice that its filing was subject to the price cap rules, the court found it unnecessary to address the FCC's alternative conclusion that the filing would have been rejected under rate-of-return criteria. Pet. App. 16a-17a.

The court determined that "[t]he text of the price cap order patently reflects both the FCC's intention to insulate the initial price caps from carrier manipulation and the FCC's recognition that its new regulatory regime creates tremendous incentives for carriers to engage in base-rate maneuvering." *Ibid.* The court rejected petitioner's argument that, in light of "isolated" references to "mid-course corrections" in the price cap order, it lacked "adequate notice that traditional mid-course corrections would cease after January 1, 1991." *Id.* at 13a. The court also rejected petitioner's contention that the Commission's adjustment in petitioner's price cap to account for anomalous 1986 data "belie[d] the Commission's argument that the price cap rules provided the exclusive means by which to raise the price cap." *Id.* at 14a.

ARGUMENT

Petitioner contends that the court of appeals erred in holding that the *LEC Price Cap Order* gave it adequate notice that its proposed tariff filing was subject to the price cap rules. That contention does not warrant further review. The court of appeals merely applied the principles of fair notice enunciated in its precedent to the facts of this case. Petitioner does not, and cannot, contend that those principles conflict with any decision of this Court or that of any other court of appeals.

1. Petitioner argues (Pet. 9-17) that the court of appeals violated the principle of *SEC* v. *Chenery Corp.*, 332 U.S. 194 (1947). That argument is without merit.

a. The *Chenery* principle is not implicated here. *Chenery* stands for the "well established" principle that "an agency's action must be upheld, if at all, on the basis articulated by the agency itself." *Motor Vehicle Mfrs. Ass'n* v. *State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29,

50 (1983) (citing, *inter alia*, *Chenery*, 332 U.S. at 196); see also *Burlington Truck Lines, Inc.* v. *United States*, 371 U.S. 156, 168-169 (1962). The agency action at issue here was the Commission's decision to apply the price cap rules to petitioner's proposed tariff filing.

Petitioner's challenge in the court of appeals focused not on the reasonableness of the Commission's decision to apply its price cap rules, but rather on whether petitioner had adequate notice that the price cap rules would be applied. Pet. App. 9a. The court accordingly emphasized in reviewing petitioner's challenge: "[W]e do not examine the reasonableness of the Commission's intended interpretation [of its *LEC Price Cap Order*], but simply evaluate 'the clarity with which the agency made that interpretation known.'" *Ibid.* (quoting *McElroy Elecs. Corp.* v. *FCC*, 990 F.2d 1351, 1358 (D.C. Cir. 1993)).

The resolution of petitioner's challenge depended not on an application of the *Chenery* principle, but on an application of principles of fair notice of agency action. In accordance with its precedents regarding fair notice, the court independently examined the price cap order to determine whether a "fair reading" of it gave petitioner notice that the price cap rules would apply to its proposed tariff filing. See, *e.g.*, *McElroy Electronics*, 990 F.2d at 1358; *Maxcell Telecom Plus, Inc.* v. *FCC*, 815 F.2d 1551, 1558 (D.C. Cir. 1987); *Bamford* v. *FCC*, 535 F.2d 78, 82-85 (D.C. Cir.), cert. denied, 429 U.S. 895 (1976).

Nothing in *Chenery* barred the court from making such an independent assessment. In particular, the court was not limited to reviewing the portions of the price cap order that the FCC relied upon when it rejected petitioner's fair-notice argument in its initial order and its order on remand in this case. As the court explained, "[a]lthough the agency's interpretation of its

own orders is ordinarily entitled to deference, [a court must] pay strict heed to whether the agency provided affected parties with full notice of the *content* of those interpretations." Pet. App. 9a-10a.

In sum, *Chenery* did not require the court of appeals to limit its inquiry to the agency's explanation of why its price cap order provided adequate notice that the price cap rules would apply to petitioner's proposed tariff filing. Instead, the court was required, under its precedents regarding fair notice, independently to determine whether the price cap order gave adequate notice of the applicability of the price cap rules. Petitioner does not, and cannot, contend that the principles of fair notice established by the D.C. Circuit, and applied here, conflict with *Chenery* or with the decisions of any other court of appeals. Further review is therefore not warranted.[4]

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[4] Petitioner argues (Pet. 13-15) that certain statements by the Commission in its initial order and its order on remand in this case undermine the court of appeals' conclusion that the *LEC Price Cap Order* gave petitioner adequate notice of the applicability of the price cap rules. The statements upon which petitioner relies, however, were made long after petitioner filed its proposed rate increase. Consequently, those statements could not have influenced petitioner's understanding of what the *LEC Price Cap Order* meant "at the time the [price cap] order was issued." *McElroy Elecs.*, 990 F.2d at 1358. The court of appeals has correctly recognized that, in cases involving fair-notice claims, "the contents of the order itself are the most important consideration." *Id.* at 1362. Here, the court of appeals properly focused on the contents of the *LEC Price Cap Order* in deciding whether that order provided fair notice. As discussed *infra*, p. 15, the court also considered statements in the Commission's subsequent orders insofar as they were relevant to determining whether the price cap order provided adequate notice.

b. In any event, even if the *Chenery* principle did apply here, the court of appeals did not violate it.

i. Contrary to petitioner's claim (Pet. 10; see also Pet. 13-14), the court of appeals did not improperly rely "on arguments and explanations that appeared for the first time in the FCC's appellate counsel's brief" in holding that petitioner had adequate notice that its proposed tariff filing was subject to the price cap rules. Petitioner bases that claim (Pet. 13-14) on the fact that both the court of appeals and the FCC's brief on appeal relied on paragraph 245 of the *LEC Price Cap Order* in addressing the notice issue. But the Commission itself relied upon paragraph 245 in concluding that petitioner had adequate notice. Pet. App. 19a-20a n.4. Thus, petitioner is wrong in suggesting (Pet. 13) that paragraph 245 was raised "for the first time" in the FCC's appellate brief.[5]

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[5] Petitioner attempts (Pet. 13) to attach significance to the fact that the court of appeals and the FCC's brief on appeal quoted and discussed paragraph 245 at some length, whereas the Commission merely cited it without discussion. The attention to paragraph 245 at the court of appeals level, however, stems from the fact that the Commission and petitioner disputed its import. Petitioner relied on the single statement in paragraph 245 that "[d]uring the period between the July 1, 1990 date . . . and the January 1, 1991 start date of price cap regulation, LECs remain free to introduce new effective prices justified under existing rate of return cost support requirements." Pet. App. 13a (quoting *LEC Price Cap Order*, 5 F.C.C. Rcd. at 6816 (¶ 245)). Petitioner argued that this statement indicated that its application for a rate increase would be reviewed under rate-of-return criteria. Pet. App. 13a. The court of appeals rejected that argument; it determined that, "rather than support [petitioner's] argument, * * * this statement undermines it," when the statement is read in light of "the avowal" that immediately followed it:

Moreover, as petitioner concedes (Pet. 14), the court of appeals cited many other paragraphs of the *LEC Price Cap Order* to support its conclusion that petitioner had adequate notice. Pet. App. 10a-11a (citing paragraphs 189, 230, 232, 241, and 243 of price cap order). The court's reliance on those other paragraphs, which were not cited in the FCC's brief on appeal, belies petitioner's contention that the court merely accepted appellate counsel's *post hoc* rationalization.

ii. Nor did the court of appeals "substitute [its] assessment of policy considerations" for that of the Commission, as petitioner contends. Pet. 15. Petitioner asserts that the court, and not the Commission, first came up with the rationale that applying the price cap rules to filings like petitioner's would "prevent[] LECs from engaging in pre-price cap 'maneuvering' and 'manipulation' of their costs," Pet. 15, and that "the FCC itself never relied upon that justification," Pet. 16. Those assertions are incorrect.

> [T]o the extent LEC transmittals have the effect of increasing prices for services during this six month period, our decision to inaugurate the price cap index (PCI) on July 1, 1990 and to require actual prices to be equal to or below the PCI on January 1, 1991, prevents LECs subject to price caps from engaging in a rapid escalation in prices that would have the effect of raising their price cap base rates.

Ibid. (quoting *LEC Price Cap Order*, 5 F.C.C. 2d Rcd. at 6816. (¶ 245)). The court of appeals found it "clear" from "the terms of" paragraph 245, read as a whole, that "the Commission did not contemplate that any rate increases occurring during this period would automatically raise the actual price cap for the purposes of the new regulations." Pet. App. 13a. Given the dispute over the meaning of paragraph 245, it was not surprising or improper for appellate counsel and the court to discuss it at some length.

The court of appeals correctly determined that the FCC's anti-manipulation justification for applying the price cap rules was "patently reflect[ed]" in "[t]he text of the price cap order." Pet. App. 10a. The court quoted numerous specific passages from the order that "make abundantly clear the FCC's intention to abandon ordinary mid-course corrections under its new price cap regime." *Id.* at 11a. The court cited the Commission's express recognition "that rational LECs, like [petitioner], would be motivated to elevate their costs to obtain the highest possible price cap if price caps were set prospectively." *Ibid.* The court also cited the Commission's repeated declarations "that it [had] adopted historical rates to avoid the possibility of just such manipulation." *Ibid.* The court found that the Commission's development of three specific mechanisms for upward cap adjustments in the *LEC Price Cap Order* manifested the agency's clear intent "that more rigorous hurdles awaited any attempt to raise prices that might potentially frustrate incentives for efficiency." *Id.* at 12a. Thus, the court properly examined the text of the price cap order with care and correctly found in it "ample support" for the conclusion that the price cap rules provided the exclusive mechanisms for increases in the initial price caps. *Id.* at 10a.[6]

2. The decision below does not involve any issue of broad importance warranting this Court's review.

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[6] As discussed above, p. 9, *supra*, petitioner's challenge in the court of appeals did not focus on whether the FCC adequately justified its decision to apply the price cap rules to petitioner's proposed rate increase, but focused instead on whether the *LEC Price Cap Order* gave petitioner adequate notice of the applicability of the price cap rules. Accordingly, the court of appeals cited the anti-manipulation justification articulated in the *LEC Price Cap Order* to show that the order provided adequate notice.

a. The factual situation involved here will not recur. The LECs subject to the price cap system have completed the transition to that system. Consequently, there is no continuing importance to the question whether affected LECs had adequate notice of what standards would apply to proposed rate increases that were filed during the transition period and that would have the effect of increasing price caps. Moreover, although petitioner asserts (Pet. 17) that it will suffer economic harm from the decision below for years to come, nothing in that decision bars it (or any other affected LEC) from filing a request for an upward cap adjustment that complies with the price cap rules.

b. Petitioner asserts that the court of appeals has "set a dangerous precedent with potentially broad implications" (Pet. 10) by "establish[ing] a dangerously low standard" (Pet. 18) for determining whether an agency has provided adequate notice of the manner in which it interprets its orders. That assertion mischaracterizes the standard that the court of appeals applied.

The court of appeals stated the controlling standard as follows (Pet. App. 9a, quoting *McElroy*, 990 F.2d at 1358):

> elementary fairness requires "not . . . that the agency have made the clearest possible articulation," but "only that, based on a 'fair reading' of its order, the petitioners knew or should have known what the Commission expected of them."

The court explained that "[t]he key factor for our purposes is that the order be 'reasonably comprehensible to [people] acting in good faith.'" Pet. App. 9a (quoting *Maxcell Telecom Plus, Inc.* v. *FCC*, 815 F.2d 1551, 1558 (D.C. Cir. 1987)). Ultimately, the court determined that "the price cap order, fairly read, provided sufficient notice to alert LECs that increases to the July 1, 1990

price cap that were to go into effect after January 1, 1991 could be accomplished only through the three mechanisms set forth in the order." Pet. App. 3a.

The court of appeals did not ignore the passages in the Commission's orders that petitioner claimed to be contrary to the court's reading. The court examined those passages, which referred to "mid-course corrections," with great care. Pet. App. 13a-16a. The court determined that the "isolated" references to "mid-course corrections" in the price cap order did not "have the effect of signalling an intent to preserve the mid-course correction status quo contrary to the basic thrust of the text of the order." *Id.* at 14a. With regard to the reference to "mid-course corrections" in the order on remand in this case, the court determined that, while the reference was "admittedly opaque and even superficially contradictory," it was "most reasonably directed to the [three prescribed] escape mechanisms of the new price cap scheme." *Id.* at 15a-16a.

The court's "careful review" (Pet. App. 10a) of the Commission's orders demonstrates that the court will not "smooth over" (Pet. 18) any inconsistencies in reviewing an agency's decision, as petitioner fears. Moreover, the court warned that "the FCC courts danger when it uses impenetrable, imprecise language." Pet. App. 16a. The court also made clear that its holding was a narrow one, reflecting no more than an application of the notice standard established by its precedents to the facts of this case: "In this particular instance, * * * given the relative clarity with which the price cap order itself mandates rejection of [petitioner's] filing, we find insufficient cause for reversal." *Ibid.*

Petitioner does not challenge the standard underlying the court of appeals' decision or suggest that the standard conflicts with any decision of this Court or that of

any other court of appeals. Petitioner simply disagrees with the application of that standard to the facts of this case. Further review is therefore not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

WILLIAM E. KENNARD
General Counsel

JOHN E. INGLE
Deputy Associate General Counsel

JAMES M. CARR
Counsel
Federal Communications Commission

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PETITIONER'S REPLY BRIEF

MARTIN E. GRAMBOW
Southwestern Bell Corporation
—Washington, D.C.
1401 I Street, N.W., Suite 1100
Washington, D.C. 20005
(202) 326-8868

JAMES E. TAYLOR
RICHARD C. HARTGROVE
THOMAS A. PAJDA
Southwestern Bell Telephone Company
One Bell Center, Room 3520
St. Louis, Missouri 63101
(314) 235-2507

JOHN I. STEWART, JR.*
ROBERT M. HALPERIN
STEPHEN M. BYERS
CROWELL & MORING
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2595
(202) 624-2500

* *Counsel of Record for the Petitioner*

June 3, 1994

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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PETITIONER'S REPLY BRIEF

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1. In their Brief in Opposition, the Respondents now argue that the court of appeals was simply not bound to follow that "fundamental rule of administrative law" first articulated by this Court in *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947). They insist instead (Opp. 8-10) that the court of appeals was engaged in an exercise of "independent assessment" that freed it from the requirement to accommodate the agency's actual grounds in affirming the agency's decision. That argument is wrong.

a. First, the argument misapprehends the nature of the question before the court of appeals. The FCC had

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[1] Pursuant to Rule 29.1, the petitioner's parent company and affiliated subsidiaries were listed in the Petition, at ii.

ultimately decided that its 1990 Price Cap Order barred the kind of tariff filing made by petitioner because, it found, the new price cap adjustment mechanisms adopted in that order were applicable to such pre-price cap filings. (Pet. App. 21a-25a). Petitioner argued that this decision was unlawful, since it constituted the retroactive application of a preclusive new interpretation of the Price Cap Order as to which there had been no prior notice. In affirming the FCC, the court of appeals determined that the Price Cap Order *did* impose the bar the FCC inferred from it, and did so in terms clear enough to constitute adequate notice of the new rule. (Pet. App. 16a, 17a). Thus, what the court of appeals engaged in was a direct review of the essential merits of the agency's decision. In doing so, the court was not excused from compliance with *Chenery*.

The Respondents' proffered distinction between review of the reasonableness of an agency's decision and review of the adequacy of notice of that decision (Opp. 9) is to no avail. Here those questions are inextricably intertwined. The FCC did not purport to decide in 1993 whether petitioner could make a certain kind of tariff filing, but only whether that decision had already been made in its 1990 Price Cap Order. The court's review was necessarily limited to whether the FCC's interpretation of its own 1990 order was reasonable, and the court was bound to reverse the FCC if the grounds the agency relied upon to justify its interpretation were inadequate.

Indeed, because of the posture of the case before the agency (it had been remanded after the notice issue had already been raised), the FCC expressly held that petitioner had received adequate notice of the preclusive rule it had discovered in its 1990 Price Cap Order. (Pet. App. 25a). The court's consideration of the same question on appeal was thus a direct review of the agency's determination, not an independent and unrelated inquiry outside the strictures of *Chenery*.

In any event, the argument pressed by the Respondents ultimately makes no sense in light of the purposes of the *Chenery* rule. Even if the question before the court of appeals had been a collateral issue requiring independent review, the fundamental concerns for separation of powers and judicial and administrative efficiency underlying *Chenery* should properly have barred the court from affirming the agency based on an interpretation of the agency's orders that flatly contradicted the agency's own interpretation of those orders. The court's conclusion that the Price Cap Order had provided adequate notice of a preclusive new rule relied heavily (Pet. App. 10a-11a, 13a) on a reading of paragraph 245 of the order, suggested by appellate counsel for the FCC, that was precisely the opposite of the FCC's own explicit reading of that paragraph. (*See* Pet. 13). The distinction proposed by the Respondents would thus produce exactly the kind of judicial overreaching the *Chenery* principle was intended to prevent.

b. The court of appeals plainly violated the *Chenery* principle in its decision below. The contrary assertions of the Respondents are based on misreadings of the record and of the petition's argument.

i. The FCC did not, as the Respondents assert (Opp. 11), "rel[y] upon paragraph 245 in concluding that petitioner had adequate notice." Respondents' only support for this proposition is a citation to a string citation in a footnote in a "Background" section of the FCC's decision that does not address the question of notice. The FCC's conclusory finding of adequate notice appears in a different section of the decision, which nowhere cites or relies upon paragraph 245. (Pet. App. 25a). This is not surprising, since the FCC had previously interpreted paragraph 245 as meaning precisely the opposite. (Pet. App. 42a-43a). The contradictory interpretation ultimately favored by the court of appeals was suggested for the first time in appellate counsel's brief to the court, not in any FCC decision.

ii. The Respondents also mischaracterize the record in arguing (Opp. 12-13) that the court of appeals did not arrogate to itself the assessment of regulatory policy considerations properly left to the FCC. As discussed in the Petition (Pet. 15-16), the FCC had identified a concern for avoiding pre-price cap cost manipulation by LECs. But as petitioner specifically substantiated (Pet. 16), the FCC relied upon that justification only to engage in "heightened scrutiny" of petitioner's filing under conventional rate of return analysis, and never to justify the preclusive application of the new price cap adjustment mechanisms.[2] Although the court of appeals found support for affirming the FCC's ultimate holding in the FCC's discussion of certain policy concerns in its Price Cap Order,[3] the FCC itself did not rely upon that justification. This is precisely what *Chenery* prohibits.

2. The arguments of the Respondents cannot obscure the simple fact that the court of appeals, when faced with a set of utterly irreconcilable agency rationalizations for the rejection of the petitioner's tariff filing, supplied a different rationalization. In affirming the FCC's decision, the court not only relied on reasons the FCC had not adopted, but it relied on interpretations of a prior FCC order that contradicted the FCC's own interpretation of that same order. Such substitution of judgment violates the holdings of this Court in *Chenery* and its progeny, and should not be allowed to stand. The deci-

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[2] Remarkably, the Respondents misquote the petitioner's argument (*compare* Opp. 12 *with* Pet. 16) before asserting that it is incorrect. The petitioner never argued, as Respondents claim, that the FCC failed to address cost-manipulation concerns, only that it relied upon them to justify a different remedy than the one the court of appeals affirmed on the basis of those same concerns.

[3] Again, the court relied for this conclusion principally on its interpretation of paragraph 245 of the Price Cap Order, which the FCC had interpreted to the opposite effect. *Compare* Pet. App. 10a-11a, 13a *with* Pet. App. 42a-43a.

sion of the FCC must be upheld, if at all, only on the basis articulated by the FCC itself.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

MARTIN E. GRAMBOW
Southwestern Bell Corporation
—Washington, D.C.
1401 I Street, N.W., Suite 1100
Washington, D.C. 20005
(202) 326-8868

JAMES E. TAYLOR
RICHARD C. HARTGROVE
THOMAS A. PAJDA
Southwestern Bell Telephone Company
One Bell Center, Room 3520
St. Louis, Missouri 63101
(314) 235-2507

JOHN I. STEWART, JR.*
ROBERT M. HALPERIN
STEPHEN M. BYERS
CROWELL & MORING
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2595
(202) 624-2500

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* *Counsel of Record for the Petitioner*